S. HRG. 112–758

TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

HEARING

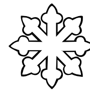
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

APRIL 25, 2012



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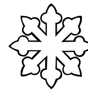

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TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

WEDNESDAY, APRIL 25, 2012

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:11 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Cantwell, Nelson, Cardin, Hatch, Snowe, and Thune.

Also present: Democratic Staff: Lily Batchelder, Chief Tax Counsel; Holly Porter, Tax Counsel; Tiffany Smith, Tax Counsel; and Ryan Abraham, Tax Counsel. Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Nick Wyatt, Tax and Nomination Professional Staff Member; and Jim Lyons, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

In Federalist Paper No. 41, James Madison wrote that one of the powers conferred on the Federal Government is the "maintenance of harmony and proper intercourse among the States."

When Madison and our founders crafted the Constitution, they debated the proper division of power between the Federal and State governments. Today we examine that question when it comes to the tax code.

Most State governments are in tough financial shape. In 2010, 48 States had budget shortfalls. All States except one are required by State law to balance their budgets. That has forced States to make tough decisions, such as raising taxes or cutting spending.

Since the financial crisis, 46 States have cut services; 30 have raised taxes. To help States and local governments balance their budgets, the Federal Government provides direct support through programs like Medicaid. Thirty-six percent of all State revenues come from Federal grant programs.

The Federal Government has also long played an indirect role boosting State and local governments through the tax code. Since the first income tax law, Congress has exempted interest on State and local bonds. This exemption helps cover part of the borrowing cost of projects by State and local governments. The interest exemption on bonds totals about $50 billion a year.

The same is true for State and local taxes; that is, the tax deductions. Since 1913, Congress has allowed some or all of the State and local income, general sales, excise, and real property and personal property taxes to be deducted from income for Federal income tax purposes. That totals about $66 billion a year.

These tax exemptions and deductions total more than twice what the Federal Government provides to States in highway funding. Combined, they cost more than $105 billion per year or, if you add in the private activity bonds, close to about $115 or $116 billion a year.

During hard economic times, this Federal support helps cushion the blow on State and local finances. It also ensures that State and local governments play a role in deciding how some Federal dollars are spent. For example, making the interest on bonds tax-exempt reduces the interest rate State and local governments pay to finance roads, schools, hospitals, and other construction projects. Just this February, voters in Manhattan, MT approved new bonds so the community can afford to repair the Manhattan Elementary School's roof.

Likewise, the deduction for State and local taxes reduces the burden that a State or local government places on its own residents in raising revenue. As we reform the tax code to encourage growth and make our country more competitive, we need to ask whether the current exemptions and deductions make sense.

State and local taxes could potentially be allowed as above-the-line deductions, allowing all taxpayers to benefit. We could also consider providing a uniform subsidy for bondholders. Tax-exempt bonds subsidize interest paid on such bonds by exempting the interest from the tax, and, currently, the value of this subsidy varies based on taxpayers' marginal income tax rates.

For every dollar we spend on infrastructure through a tax-exempt bond, $0.20 goes to tax breaks for higher-income taxpayers. A uniform subsidy would mean each taxpayer receives the same subsidy regardless of tax bracket. The Build America Bonds Program achieved success using just this approach.

In Montana, the Barrett Hospital in Dillon was outdated and in need of constant repair. Dillon issued $30 million of insured Build America Bonds at a 3.67-percent interest rate, reducing the borrowing cost to Dillon residents by a full percentage point, saving them more than $800,000. The project created 33 full-time jobs. Dillon now has a new, state-of-the-art critical access hospital.

Beyond these provisions in current law, we should also ask what else we can be doing to efficiently help State and local governments maintain sustainable budgets. We need to make sure our Federal, State, and local tax systems are working together. As part of tax reform, we should ask how we can help States collect taxes owed and how we can encourage standard rules to protect taxpayers from multiple taxes and needless complexity.

We have worked together with the States to simplify rules in the past. Originally driven by the States, the international fuel tax agreement provides a uniform system for the administration and reporting of fuel taxes paid by commercial trucks and buses operating in multiple States. States agreed to simplified administration burdens in exchange for ability to enforce fuel use taxes.

More recently, Congress enacted the Mobile Telecommunications Sourcing Act to establish uniform rules under which the States can tax mobile calls.

We should consider how we can learn from these examples. So we must work to reform the code. Let us remember the lessons from Madison and our Founders. Let us bear in mind the relationship between our Federal tax code and State and local tax systems and improve the code to create growth and make the U.S. more competitive. And let us do this in a way that improves Federal, State, and local budgets.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. In reading the written testimony of our guests today, I was particularly struck by Mr. Hellerstein's recitation of the Hippocratic Oath: "First, do no harm."

Too often, Congress forgets this sensible advice. My hope is that this hearing, drawing on the wisdom of our five witnesses, will help Congress observe and honor Mr. Hellerstein's admonition. The rush for new tax dollars that too often characterizes the Federal legislative process oftentimes leaves issues involving Federal-State tax coordination by the wayside. But we cannot forget that the policies being discussed today touch on fundamental constitutional principles—principles of federalism and separation of powers. And, if we are to do no harm, it is important to hold hearings such as this one.

Though I do not have all the answers to the specific policy questions this particular hearing will wrestle with, I do have a series of bedrock principles that I believe will serve as a useful guide.

The 10th amendment to our Constitution serves as the lodestar for today's hearing. As the testimony of our witnesses at least implicitly reminds us, under our Constitution of enumerated and limited Federal powers, the powers not delegated to the United States by the Constitution or prohibited by it to the States are reserved to the States, respectively, or to the people.

Now, issues involving the Federal impact on State and local revenues impact both the Constitution's separation of powers between the Federal and State Governments and the separate identity of the sovereign States.

Too often, some view the Constitution and its limits on Federal power as a hindrance to important objectives. I cannot subscribe to this approach. We all take an oath to protect and defend the Constitution. That Constitution, with its limits on Federal power, is our greatest strength, not weakness. And in walking the fine line between Federal and State powers, we need to be especially mindful of our oath.

Federal discussions about State finances frequently highlight budgetary pressures that have required cuts in spending. These are no doubt difficult issues for States, but it simply is not the respon-

sibility of the Federal Government to address State budget shortfalls.

Some argue that the recent recession has uniquely harmed State revenues, somehow justifying the use of the Federal Government as a backstop. Yet, as the Census Bureau noted in an April 12, 2012 report, State government tax collections in fiscal year 2011 were actually up nearly 8 percent from the revenue collected in fiscal year 2010.

Something else is driving State budget shortfalls, and I think, in many instances, the principal issue for States is their own unsustainable spending. Also, it is important to recall that the States are already receiving significant support from Federal taxpayers. According to the Joint Committee on Taxation, Federal deductions for State and local taxes will diminish Federal taxes by about $347 billion from 2011 to 2015.* These deductions are generally regarded as helping States to leverage spending by minimizing the true cost of State and local government. And, as someone dedicated to States' rights, I believe that a State should be free to set its own tax and spending policies.

But with rights come responsibilities, and State officials need to take responsibility for their own spending decisions.

In closing, I want to show my appreciation to the members of this committee who have a strong interest in these issues involving Federal and State interaction. I know Senator Enzi has worked very hard for many years on what is now the Marketplace Fairness Act. Senator Thune and Senator Wyden have proposed the Digital Goods and Services Tax Fairness Act. Senators Snowe, Wyden, Menendez, and Nelson are cosponsors of the Wireless Tax Fairness Act. Now, your work on these issues is a resource for all of us, and I look forward to continuing to work with all of you.

And thank you, again, Mr. Chairman. The work already done in this area, which is substantial, and the opportunities facilitated by this hearing, will help us ensure that when we go down the road of comprehensive tax reform, we do no harm and possibly even accomplish some good. So I am grateful for this hearing.

Thanks so much.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Thank you, Senator.

I would now like to introduce our witnesses. First is Mr. Frank Sammartino. Mr. Sammartino is the Assistant Director for Tax Analysis at the Congressional Budget Office. Thank you very much, Mr. Sammartino. We depend on you a lot. Thank you for all your work.

Next is Dr. Kim Rueben. Dr. Rueben is a senior fellow at the Urban-Brookings Tax Policy Center. Thank you for being here, Dr. Rueben.

The third witness is Mr. Walter Hellerstein. Mr. Hellerstein is the Francis Shackelford professor of taxation at the University of Georgia School of Law.

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*For more information, *see also,* "Present Law and Background Information Related to State and Local Government Finance," Joint Committee on Taxation staff report, April 23, 2012 (JCX–36–12), *https://www.jct.gov/publications.html?func=startdown&id=4422*.

Fourth is Mr. Joseph Henchman, vice president of legal and state projects at the Tax Foundation.

Finally, Mr. Sanford Zinman, owner of Zinman Accounting in White Plains, NY.

Thank you all for coming.

Our practice here is for your statements automatically to be included and for each of you to speak about 5 minutes.

It is also my practice—all of you probably have prepared written statements. You can read them if you want, but just tell it like it is. Do not pull your punches. Be candid.

Mr. Sammartino?

STATEMENT OF FRANK SAMMARTINO, ASSISTANT DIRECTOR FOR TAX ANALYSIS, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Mr. SAMMARTINO. Chairman Baucus, Senator Hatch, members of the committee, thank you for the invitation to testify on Federal support for State and local governments provided through the tax code and on some ways in which tax reform might affect that support. My testimony focuses on two particular aspects of current policy—the use of tax-preferred bonds by State and local governments and the deductibility of State and local taxes.

The Federal Government provides preferential tax treatment for bonds issued to finance activities of State and local governments. As a result, those governments are able to borrow more cheaply than they otherwise could. At the end of 2011, State and local governments owed roughly $3 trillion in the form of tax-preferred bonds.

The most common type of tax-preferred bond is one for which interest income is exempt from Federal taxes. Another type of tax preference for a State and local bond, which until recently has not been much used, is to offer a Federal tax credit in lieu of some or all of the interest income from the bond.

Although a large majority of tax-preferred bonds are traditional tax-exempt bonds, such bonds are relatively inefficient mechanisms for the Federal Government to transfer funds to State and local governments. Specifically, with tax-exempt bonds, the Federal Government forgoes more in tax revenues than State and local governments receive. Estimates suggest that the difference is about $6 billion per year or about one-fifth of the approximately $30 billion in Federal revenues lost through that tax preference. That sum accrues to investors who pay high marginal tax rates.

In contrast, for tax credit bonds, the revenues foregone by the Federal Government are captured entirely by State and local governments. However, tax credit bonds have not been especially well received in financial markets until a few years ago. Investors' lack of enthusiasm for such bonds probably stemmed from the limited size and temporary nature of most tax credit bond programs and an absence of rules for separating tax credits from the associated bonds and reselling them.

In contrast, direct-pay tax credit bonds, for which the value of the tax credit takes the form of a payment from the Treasury to the State or local government issuing the bond, became a signifi-

cant source of State and local financing in the years during which they were authorized, namely, 2009 and 2010.

The deductibility of State and local taxes provides another means of Federal support for State and local governments. Taxpayers who itemize their deductions may claim a deduction from most State and local taxes. That taxes-paid deduction provides an indirect Federal subsidy to State and local governments because it decreases the net cost to taxpayers of paying such deductible taxes.

By lowering the net cost of those State and local taxes, the taxes-paid deduction encourages State and local governments to impose higher taxes and provide more services than they otherwise would and to use deductible taxes in place of other taxes.

According to an estimate by the staff of the Joint Committee on Taxation, the tax subsidy provided through this deduction was $67 billion in 2011.

How much a given State or local government benefits from this deduction depends on the structure of its tax system and the characteristics of the taxpayers who provide revenues to it. For example, a State or local government that finances its spending by using a larger share of deductible taxes receives a larger benefit through the deductibility provision, as does the State or local government whose taxpayers are more likely to itemize deductions.

In 2009, slightly fewer than one-third of all tax filers claimed the deduction for State and local taxes paid. The amount of those taxes paid, the tax savings from the deduction, and the likelihood that a taxpayer would claim the deduction all generally increase with increasing taxpayer incomes.

Over the next several years, scheduled changes to tax provisions and the interaction of the regular income tax and the alternative minimum tax will change the number of taxpayers who claim the deduction and the associated loss of Federal revenues, because the AMT does not allow people to claim the taxes-paid deduction.

Without further changes to tax law, tax provisions that were originally enacted in 2001 and 2003 will expire at the end of 2012, increasing regular income tax rates for many taxpayers. Those increases will raise the value of the taxes-paid deduction for those who claim it and increase the associated revenue loss for the Federal Government.

In addition, with the higher tax rates, many taxpayers will shift from being subject to the AMT to being subject to only the regular income tax and will, therefore, be able to claim the deduction for State and local taxes paid.

If certain tax policies that have recently been in effect were extended rather than allowed to expire, as under current law, the revenue effects of the taxes-paid deduction would be different.

Specifically, if all tax provisions expiring after 2012, including the lower regular income tax rates originally enacted in 2001 and 2003, were extended and the AMT exemption levels were increased for years after 2011, there would be two opposing effects on the taxes-paid deduction. First, the lower regular income tax rates would reduce the tax savings and the associated revenue loss for the Federal Government for taxpayers claiming the deduction, but, second, the higher AMT exemption levels would reduce the number

of taxpayers subject to the AMT, thereby increasing the number of taxpayers who would claim the deduction.

That concludes my opening testimony. I will be happy to answer questions.

[The prepared statement of Mr. Sammartino appears in the appendix.]

The CHAIRMAN. Thank you very much, sir.

Dr. Rueben, you are next.

STATEMENT OF DR. KIM RUEBEN, SENIOR FELLOW, URBAN-BROOKINGS TAX POLICY CENTER, WASHINGTON, DC

Dr. RUEBEN. Thank you. Chairman Baucus, Senator Hatch, and members of the committee, thank you for inviting me to be here today. I am thrilled that you are having this hearing about how Federal reform will affect State and local governments.

With increasing concerns about the Federal deficit, fairness, and the complexity and inefficiency of our tax system, the need for fundamental Federal tax reform is critical. Often overlooked, however, is the fact that any such reforms will also affect the tax and fiscal policies of State and local governments.

As mentioned by you, Mr. Chairman, before, although this country's economic condition is improving, State and local governments are still struggling to balance their budgets. They also play an important role in our economy, running about half of all domestic public programs, and with State and local spending making up about 15 percent of GDP.

Decisions about changing Federal policy should take into account the potential effects on State and local government budgets in both the short and the long run.

I make four points today. First, Federal tax policy and reform can help or hurt States. Second, unstable Federal tax policy trickles down to the States, and uncertainty is especially problematic for States' budgeting. Third, if fundamental tax reform is undertaken, transition relief might be important for State and local governments. And, finally, Congress can play a role in helping to coordinate or protect the existing State and local tax base.

Returning to the first point, Federal tax policy and reform can help or hurt States. Federal policy affects how attractive specific taxes are for State and local governments and, therefore, how those governments organize their tax and revenue system.

State revenue sources, especially income taxes, often piggyback on Federal rules. More specifically, statutory changes in Federal law can result in significant increases or decreases in State revenue. For example, State income tax revenues increased after the 1986 tax reform expanded the Federal income tax base and also allowed States to reduce their rates as well. In contrast, the elimination of the State and local tax deduction could increase the cost to State and local governments of providing services.

Second, unstable Federal tax policy trickles down to the States, and uncertainty is especially problematic for State and local governments. As mentioned before, State and local governments are required to pass balanced budgets every year. This requires being able to accurately forecast revenues. Problems with State tax systems are often exacerbated by uncertainty in Federal tax rules.

Temporary extensions of credits, deductions, and tax rates complicate State forecasting. Policy changes and uncertainty can directly affect State tax bases through changing definitions of income or indirectly due to changes in taxpayer behavior. Especially problematic has been uncertainty about future Federal estate taxes, tax rates on dividends and income, and dividends and capital gains, sources of volatile income for State governments.

Third, if fundamental tax reform is undertaken, and I hope it is, transition relief might be important for State and local governments. Tax changes can help or hurt States, but understanding the short-run effects will be important and may require slower adoption of certain policies or some fiscal relief. Understanding the state of the economy and the fiscal health of State and local governments will be critical in undertaking any reform.

Finally, due to our federalist system, Congress has a role in helping to coordinate or protect the existing State and local tax base. State and local governments' ability to raise revenue can be hobbled by limitations that Congress could remove. Most notably, Congress can enact legislation that could help coordinate actions across States and would help enable State and local governments to collect taxes on Internet and mail-order sales.

As we consider tax reform, it is important to remember that our actions will also affect State and local governments.

Thank you, again, for inviting me to appear today. I look forward to your questions.

[The prepared statement of Dr. Rueben appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Rueben, very much.

Mr. Hellerstein?

STATEMENT OF WALTER HELLERSTEIN, FRANCIS SHACKELFORD PROFESSOR OF TAXATION, UNIVERSITY OF GEORGIA SCHOOL OF LAW, ATHENS, GA

Mr. HELLERSTEIN. Thank you, Mr. Chairman. I am honored by your invitation to testify today, and I hope I can be of assistance to the committee.

My remarks this morning will be limited to horizontal tax coordination—coordination among State tax regimes—although my written testimony also addresses vertical tax coordination—coordination between Federal and State tax regimes.

In considering Federal legislation affecting horizontal tax coordination, I think Congress should be guided by three overarching objectives. First, Congress should seek to remove the unreasonable burdens that State taxes impose on interstate commerce. Second, in pursuing the first objective, Congress should not unreasonably restrict the States from exercising their essential taxing powers to fulfill their constitutional obligations within our Federal system. Third, when possible, Congress should strive to achieve both objectives at once, a point that the chairman has already made.

Thus, Congress can both prescribe the manner in which States may tax interstate commerce, thereby removing burdens that complex State regimes impose on interstate commerce, while, at the same time, enable States to exercise their taxing power by eliminating preexisting judicially imposed constraints on State taxing power that were designed to prevent the very burdens that Con-

gress has removed through its legislation. I would like to offer the committee two examples of the third type of intervention, one of them recently enacted, one of them now pending before Congress.

In my view, the Mobile Telecommunications Sourcing Act, to which the chairman has already referred, enacted by Congress in 2000, is a poster child for horizontal Federal-State tax coordination at its best. Prior to this Act, the States' power to tax interstate telecommunications was governed by the rule announced by the U.S. Supreme Court under the dormant Commerce Clause in the case called *Goldberg v. Sweet.* In *Goldberg,* the Court held that the only States that have jurisdiction to tax the consumer's purchase of an interstate telephone call are States where the call either originates or terminates and is charged or billed. But this rule often left the States powerless to tax wireless telecommunications, as, for example, when a business traveler who lives in State A, where she received and paid her monthly phone bill, made a call while on business in State B to a person in State C.

These and related difficulties led Congress, with the joint support of the telecommunications industry and the States, to enact the Mobile Telecommunications Sourcing Act, which permits the State to tax all mobile telecommunication charges for services provided by the customer's home service provider at the customer's place of primary use, but only at the place of primary use.

Congress both expanded and contracted State taxing power by reference to the preexisting dormant Commerce Clause standard established by *Goldberg,* simultaneously conferring such power upon and limiting it to the customer's place of primary use.

The Mobile Telecommunications Sourcing Act is, thus, a model for Federal-State horizontal tax coordination. It employs Congress's power to both expand and restrain State tax power in a manner that allows taxes to be collected in a sensible manner, and, at the same time, protects taxpayers from multiple taxation.

Let me turn, finally, to what I regard as an analog to the Mobile Telecommunications Sourcing Act and several related bills that are presently pending before Congress relating to the States' power to require out-of-state sellers who have no physical presence in the State to collect the sales or use taxes that are due on their sales to customers in the State.

Just as the U.S. Supreme Court's decision in *Goldberg* was essential to understanding the problem addressed by the Mobile Telecommunications Sourcing Act, so the U.S. Supreme Court's decision in *Quill Corporation v. North Dakota* is essential to understanding the problem addressed by the proposed legislation. *Quill* held that States have no power under the dormant Commerce Clause to require mail-order sellers to collect sales and use taxes on sales to customers in the State unless they are physically present in the State. The proposed congressional legislation, reflected in three bills, is designed to authorize the States under specified conditions, generally requiring harmonization and simplification of their sales and use tax regimes, to require collection of sales and use taxes by remote sellers despite their lack of physical presence in the State.

Although the bills differ in their detail, they share in common the concept of a deal authorizing collection of taxation from remote sellers in return for removal of existing burdens on such sellers

through simplification and harmonization, as well as the provision of tax-compliant software.

Without burdening this morning's hearing with the nuances of my views on the different bills—they are contained in my written testimony—I would say that legislation along the lines of these proposals is precisely the type of horizontal tax coordination that Congress should be considering, on the one hand, and uses Congress's power to provide for increased uniformity and simplicity among State tax regimes, as well as the availability of tax-compliant software, thereby reducing burdens on interstate business, on the other hand. And, at the same time, it uses Congress's power to remove judicial restraints from the States' taxing power that were attributable to the burdens that Congress's requirement of uniformity have now removed.

Thank you for the opportunity to address this committee.

[The prepared statement of Mr. Hellerstein appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Hellerstein, very much.

Mr. Henchman?

STATEMENT OF JOSEPH HENCHMAN, VICE PRESIDENT OF LEGAL AND STATE PROJECTS, TAX FOUNDATION, WASHINGTON, DC

Mr. HENCHMAN. Good morning. Thank you, Mr. Chairman, Mr. Ranking Member, members of the committee. Thank you for the opportunity to testify today on the role that Congress plays in State tax policy.

In the 75 years since our founding, the Tax Foundation has monitored tax policy at the Federal and State levels, and our analysis is guided by the principles of economically sound tax policy—simplicity, neutrality, transparency, and stability.

The main question I want to answer for you is, what is Congress's role in State tax policy? After all, to be an American is to be a believer in federalism, and that means Congress has its areas and the States have their areas. Most of the time, Congress should let the States do their thing, even if it is bad policy. But, in a very few important situations, Congress has the power and the responsibility to get involved in State tax policy—two situations, in fact.

The first is to preserve the power of the Federal Government. States cannot tax the Federal Reserve, for instance, and there are Federal laws banning State taxes on non-resident members of Congress and non-resident members of the military.

The second situation goes to the reason why we adopted the Constitution in the first place, which was mentioned by the chairman in his opening statement. States went wild under the Articles of Confederation. Port States put punitive taxes on commerce going to interior States and vice versa. Tariff wars proliferated.

So the Constitution was adopted, giving Congress the power to restrain States from enacting laws that harm the national economy by discriminating against interstate commerce.

In short, States will put their own interests ahead of the Federal interests every time. They have an incentive to shift tax burdens from physically present individuals and businesses to those who are beyond their borders, non-voters. And, when this behavior is

not prevented by Congress or the courts, the results can be taxpayer uncertainty, incompatible standards, and harm to national economic growth.

As one example, take a multistate corporation with operations in five States. If each of those five States imposes a State corporate income tax, the companies' profit must be divvied up or apportioned among those five States. That is so no State taxes more than its fair share and no multiple taxation occurs.

States game this, bending their apportionment rules to tax profits that were earned in other States. Congress recognized this problem and set up the Willis Commission in 1959 to adopt one uniform apportionment standard. That threat was successful in getting the States to adopt one on their own, although, without congressional force backing it up, the States began drifting away from it soon afterwards, and today only 11 States stick with that uniform apportionment rule. The rest have abandoned it to grab revenue from other States.

There are similar situations today which cry out for a uniform standard, which I describe in detail in my written statement. Just to highlight one problem, this is BNA's survey of State tax departments. It is a compilation of State questionnaire results on nexus-creating activities for business activity taxes.

According to the survey results, 13 States find that you are within their taxing jurisdiction if you have a website hosted on another entity's server in that State. One State and DC will tax you if you send employees to attend a seminar, even if you engage in no sales activity. This volume, while the best source we have today for businesses asking when they can be subject to tax, is littered with footnotes, exceptions, and appendix notations, reinforcing the lack of clarity the States have imposed on those who engage in interstate commerce.

We at the Tax Foundation get calls all the time from taxpayers caught in a trap by aggressive State nexus standards. The same is true with individual income taxes on business travelers, with sales tax, and with many other State taxes.

The States cannot solve these problems on their own. Congress told the States to adopt a uniform corporate income tax apportionment standard in 1959, and we are still waiting. Sales taxes, despite the work of the Streamline Project, are getting more complex and more numerous each year.

On income tax, on business travelers, or on sales taxes, the States are not budging from their positions. Today, with new technologies, even the smallest businesses can sell their products and services in all 50 States. Business travel is easier than ever before. The temptation is great to treat interstate commerce like a golden goose to be squeezed. This temptation can only be countered by well thought-out, uniform rules imposed and enforced at the Federal level.

Thank you, and, as always, we are eager to be of assistance on these issues now and in the future.

Thank you.

[The prepared statement of Mr. Henchman appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Henchman, very, very much.
Mr. Zinman?

STATEMENT OF SANFORD ZINMAN, OWNER, ZINMAN ACCOUNTING, WHITE PLAINS, NY

Mr. ZINMAN. Thank you, Mr. Chairman and members of the committee. I am a certified public accountant, I am a member of the American Institute of CPAs, and I am currently the national tax chair of NCCPAP, the National Conference of CPA Practitioners.

Accompanying me is Mr. Edward Caine, the national vice president of NCCPAP, who is a CPA in the Philadelphia area.

You have received my written testimony, and I would like to focus on some key issues. The types of taxes which impact taxpayers the most are income taxes of individuals and other entities, employment taxes, and State and local sales and use taxes.

The issue of income taxes for individuals with multistate residency is not new, but has grown in recent years. Many individuals, married or single, are purchasing second homes in other States and dividing their time between their residences. This poses a problem for these taxpayers.

In which State do they declare residency? Currently, this issue is not being decided by the individual, but by the State tax laws, and the State governments have become aggressive in seeking additional sources of revenue. Each State sets its own rules to establish and define what residency is for purposes of income taxes, sales and use tax, and estate tax. I acknowledge that Federal law should not supersede State law, but individuals are left to battle with each jurisdiction that wants a piece of the action in their tax dollars.

Businesses which have a nexus in multiple jurisdictions are also potentially subject to double or triple taxation. Although all States will acknowledge that credit should be given for taxes paid to other jurisdictions, those credits will not be given if the State perceives that the tax paid to another jurisdiction is improper. Individuals and businesses may choose to pay double taxation to avoid a lengthy administrative process. After all, these taxes are often deductible federally anyway.

Regarding employment taxes, workforce mobility is here to stay. Federal law recognizes this mobility and offers individuals and entities incentives to ensure that the workers can keep working and the companies can keep good workers. However, State and local employment laws and regulations vary greatly from State to State.

The Treasury Department regulations on uniform definition of a qualifying dependent have gone a long way toward resolving related income tax issues. A similar effort on who is an employee would be extremely helpful and would do a lot to level the playing field for employers.

Next, there is the alternative minimum tax. NCCPAP has long advocated for the abolishment of the AMT. The AMT disproportionately affects taxpayers in certain States and areas of the country, even though it is clear that was an unintended consequence of the law.

Finally, sales and use tax issues also significantly affect State and local governments. Over the past several years, in an effort to

increase revenue, States have increased their collection efforts. By the end of 2011, eight States had enacted click-through nexus provisions and more than 15 States have proposed laws expanding sales tax nexus.

The States have begun to look for any connection that an out-of-State seller might have and could be construed as a physical presence. Some States have enacted legislation imposing a sales tax liability on Internet companies if the company has an agent in the State. While most people understand the need for separation of Federal and State governments, it is apparent that there is a loss of sales tax revenue due to cross-border sales. It should also be noted that this represents a potential loss of revenue to main street small business retailers who have a physical presence in one State, but are not big enough to be a multistate retailer.

The Multistate Tax Commission, in 2011, directed its sales and use tax uniformity subcommittee to begin drafting a model nexus statute based on the *Amazon* case. There is a strong need for Federal oversight of State sales and use tax to ensure that all States are able to collect their proper tax revenue.

Thank you.

[The prepared statement of Mr. Zinman appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Zinman, very much.

We all know that the cry these days is “tax reform.” It is lower the rates, broaden the base, simplicity. A lot of people refer back to the 1986 tax reform, where there was significant rate reduction and base broadening.

Where in this area—that is, State and local taxes—can Congress look to reduce tax expenditures; that is, reduce the deduction, change the deduction, if you will, raise revenue, in order to compensate rate reduction?

Let us assume, for purposes of discussion, that we are talking about revenue neutrality here. But we all know we have a tremendous debt, national debt. And without being too dramatic here, we also know that if Congress were adjourned today, of the $15 trillion national debt that we have, if Congress adjourned today and did not reconvene until sometime next year, we would automatically shave about $9 trillion over 10 years off that national debt—$9 trillion over 10 years.

Now, that is just debt reduction. Many suggest we need to raise revenue and cut spending in order to address the debt. We know the Simpson-Bowles Commission has all kinds of proposals. Rivlin-Domenici, the Gang of 6, and so forth, almost all of them say we should reduce the national debt by $4 trillion over 10 years, and we should do it with some combination of spending cuts and revenue raised and try to get annual deficits down to at least 3 percent of GDP. That is what economists tell us is sustainable.

But in addition to tackling national debt, we have a separate problem, which is tax reform. They are separate, but they are also joint, because with tax reform, maybe we try to broaden the base and lower the rates in a way that also raises revenue.

So I just ask you. If we have to raise—let us start with the easier one. Let us say a revenue-neutral effort to lower rates and broaden the base, in this area, where do we cut tax expenditures? Where

in this area are tax expenditures reduced, in addition to other areas of the code—we have other tax expenditures that have to be reduced—in order to get the rates down?

Some talk about the corporate rate is 35 percent, getting it down to 25; some say get the top individual rate down to 25. If that means we have to cut out some deductions and credits and exclusions here, if we do all this, in this area, if we have to, if Congress really wants to, if the American public really wants to have tax reform—I am giving you time to think about this. Where do we start to chop away?

Who is boldest here and wants to lead off?

Mr. SAMMARTINO. Maybe I will. Of course, the Congressional Budget Office does not make recommendations for policy.

The CHAIRMAN. Right. Right.

Mr. SAMMARTINO. But we have, in the past, looked at various options in this area, including options to limit the State and local tax deduction, and we found that various options, from eliminating it completely to placing a cap on it or, in one case, converting it to a 15-percent credit, all would raise significant revenues over a 10-year period.

One thing we looked at, in addition, was one of the main features of the alternative minimum tax, which is that it eliminates the State and local tax deductions for taxpayers who are on the AMT.

So we considered the same set of options in the context of eliminating the AMT, and we found that for all the options we looked at, again, including complete elimination of the State and local deduction, placing a cap on it, and all those options except the option for the 15-percent credit, that if you both restricted or eliminated the taxes-paid deduction and eliminated the AMT, you would still raise revenues through that combination.

Now, these estimates were done a couple of years ago. More taxpayers would be likely eligible for the AMT. So the numbers might change, but still, that is kind of one possible tradeoff one can think about in the context of tax reform that we have looked at.

The CHAIRMAN. Right. And that approach, is it a one-for-one, or is this reduction in State revenue less than the gain in Federal revenue?

Mr. SAMMARTINO. So what we found is that if you were to completely eliminate the taxes-paid deduction and eliminate the AMT, it would still be a net revenue increase for the Federal Government.

The CHAIRMAN. And the effect on the States would be?

Mr. SAMMARTINO. I mean, the States, it is a problem, because you are reducing some of the subsidy to State and local governments. We did not examine what the impact would be. It depends on how States would respond to that.

The CHAIRMAN. I just urge you and urge all panelists and anybody else listening, anyone else who cares about tax reform, to start thinking seriously about this and coming up with some reasonable alternatives and reasonable suggestions, creative suggestions on how to do it.

Yes, Dr. Rueben? My time has expired, but very briefly, please. Briefly.

Dr. RUEBEN. I was just going to say, the other thing that happens when you make this tradeoff between the AMT and State and local deductions is you are also changing the distribution.

It is a way of shifting some of the tax burden away from families who are more likely to be on the AMT. So there is some within-State variation that occurs. But I think, in some ways, if you actually had consistent tax policy with reform of the AMT, that would be incredibly helpful for States. So you might be able to have some sort of tradeoff between limiting the deduction, if you gave them more knowledge about what tax systems would look like.

The CHAIRMAN. Thank you very much.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

This question is for the whole panel. Currently, most taxpayers who itemize have a choice of deducting certain taxes paid to State and local municipalities. Currently, deductions are allowed for State and local real property, personal property, State sales, and income taxes. Now, the Joint Committee on Taxation estimates that the revenue loss to the Federal Government will be around—well, from 2011 to 2015, these deductions will be about $347 billion, if they are extended for that time.

Now, as Mr. Sammartino notes, by lowering the net cost of those State and local taxes, the taxes-paid deduction encourages State and local governments to impose higher taxes.

My question is, how much do these deductions subsidize State and local governments? We know what the revenue loss is to the Federal Government, but even if one is comfortable subsidizing State government, is this a good way to do it?

Additionally, for Mr. Zinman, how aware is your average client of the dynamics of these deductions? Do they understand that they are viewed as a benefit to State and local government that might increase other taxes?

So whoever wants to answer that.

Mr. ZINMAN. I can tell you that 10 years ago, in my office—as I have in my written testimony—my typical client for individual income tax was not a wealthy stock trader, but a working person. Ten years ago, we did not talk about AMT at all.

Now, this is the typical conversation, and the conversation centers around how much, in my case, in the New York metropolitan area, people are paying for real estate taxes, but are not getting a deduction on their Federal tax return because of AMT. And, in fact, if nothing happens to AMT, it is projected that by 2013, 50 percent of Americans will be calculating their taxes using the alternative minimum tax calculation.

So there are a number of individuals in certain States, and that number is growing, who are now faced with an issue. Their issue is that they are paying a higher amount of State and local real estate taxes, State and local income taxes, and they are not getting the Federal tax deduction that they were hoping to get.

So the Federal income tax is not offset by what is happening, and this is starting to trouble a lot of people.

Senator HATCH. Thank you.

Does anybody else care to comment? It is pretty simple.

Let me go to a second question. President Obama has proposed to dramatically reduce the charitable deduction in his latest budget, as well as previous budgets. He does so by proposing to take away up to 29 percent of itemized deductions for families that are in either of the top two income tax brackets. Now, this appears to me to be a policy that would lead to an absolute reduction in charitable giving, and charity should be the last thing that the President is attacking, in my opinion. The President is also going after the ability of families and individuals to exclude interest on tax-exempt bonds from their income.

So this question is for the whole panel, anybody who wants to answer it. Yes or no? Let me just ask you to give a "yes" or "no."

Does everyone on this panel agree with me that the President's proposal will increase borrowing costs for State and local governments?

Mr. Sammartino?

Mr. SAMMARTINO. Well, actually, we think it might have just a minor effect on borrowing costs, because, when the State and local governments have to set an interest rate to sell the amount of bonds they want, it is usually—in order to clear the market, they have to target that rate to taxpayers with lower marginal tax rates to provide enough subsidies so those taxpayers would buy the bonds, and I think most of the evidence suggests that that rate is something below—at or below 28 percent.

So the President's proposal to limit the benefit of itemized deductions to 28 percent would not affect taxpayers whose marginal tax rate is at or below 28 percent. Taxpayers above that, if their alternative to buying tax-exempt bonds is to buy a taxable bond, would still be better off buying the tax-exempt bonds at current rates than buying a taxable bond and paying the tax.

Now, there could be some effect, because some of those taxpayers may decide that they would shift their portfolios a bit. But for most taxpayers, we think it is not going to have a very big effect.

Senator HATCH [presiding]. My time is up.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. And, obviously, one of the things that we care about in the Pacific Northwest is tax fairness and the fact that we do not have an income tax, and we want the ability to deduct our sales tax from our Federal income tax obligations. We do have a lot of itemizers because of this. And so making sure that we continue that policy and make it permanent is a big priority.

I did want to follow-up on this tax-exempt bond issue, because one of the issues for us is that some of these tax-exempt bonds are used to finance public power projects for capital investment.

And I do not know. Maybe you do not know. Dr. Rueben, I do not know if you know the answer to this or not. But what impact would this have on utility rates as a result, if we got rid of the tax-exempt bond status?

Dr. RUEBEN. I do not know what the precise rates would be, but part of it is going to depend on how transition is done. So part of the reason I think any sort of reform, especially in the muni bond market, will need to have a certain level of reform and transition

involved is because financial markets and local government revenues are still kind of not totally recovered.

So I think whatever we do—and as the Federal Government goes forward—if there is some switch in how we treat tax-exempt debt, it will be important to think about how specific localities will fare under these arrangements. And so having some sort of transition period will be pivotal in terms of being better able to understand what is going to happen in individual locations.

Senator CANTWELL. Would that missing advantage then have to be covered by ratepayers overall?

Dr. RUEBEN. Partly, it depends how it is set up. So, if we basically lower the tax-exempt status, it depends on whether it is newly issued debt or whether it is existing debt.

So existing debt, any disadvantage would actually be borne by the people who are holding the debt right now. So it is not necessarily the people issuing it.

If we moved into a new regime where there was a different system which maybe included tax credits rather than a tax-exempt status, I think it would depend on the issuing ability. And that is why I think having both systems in place, if we were going to do some transition for a little while, will be important to see whether revenue bonds can be approved at minimal cost to investors and issuers.

Senator CANTWELL. Well, I think this is an important question. So we will be following up with you and the committee on this just to make sure that public power is not disadvantaged in a bond structure, moving forward.

We are continuing to grow, and we sell a lot of power to California. We sell a lot of power all over. And making sure that people have access and continue to build the grid is something very, very important to us. It is a key element of our economy.

So thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman.

I want to thank you and Senator Hatch for holding today's important hearing, and to thank our panelists for their willingness to testify.

There are a number of very important issues regarding State and local taxation that are being discussed today, and I wanted to focus on one in particular—the taxation of digital goods and services.

Last year, I introduced, along with my colleague from Oregon, Senator Wyden, the Digital Goods and Services Tax Fairness Act. Our legislation would ensure that the fast-growing digital economy is not stymied by multiple and discriminatory State and local taxes.

Digital goods and services, such as movie and music downloads and cloud computing services, are an ever-increasing and vital part of our economy. Just as an example, in 2010, in the United States, online retailers sold over 1 billion digital music tracks, totaling $1.5 billion in revenue.

E-book sales in the U.S. reached $1 billion in 2010. They are expected to almost triple by the year 2015. And sales of downloaded apps have been especially fast-growing. In 2010, there were 8 bil-

lion apps downloaded in the U.S. Last year, there were 18 billion apps downloaded. It is projected that more than 90 billion apps will be downloaded by the year 2015. App revenue from smart phone downloads is projected to increase from $1.9 billion in 2010 to more than $29 billion by the year 2015.

So, as the digital economy grows, we need to make sure that we set some basic rules of the road so that multiple States will not attempt to tax the same downloads. The legislation that Senator Wyden and I have introduced simply clarifies that the State with the authority to tax the digital download is the State where the consumer resides. Our bill does not take away taxing authority from States. In fact, it should provide States with greater certainty going forward.

For States such as South Dakota, which does not have an income tax and which relies heavily on sales taxes, protecting the State's sales tax base is important, just as it is important that Congress extend the deductibility of State sales taxes for taxpayers who itemize, a provision that expired at the end of last year.

I hope the Senate will have an opportunity to consider the Digital Goods and Services Tax Fairness Act later this year, and I appreciate the leadership of the Senator from Oregon on this issue and look forward to working with him and with this committee and hopefully being able to move this legislation forward.

I just have a question for anybody on the panel. You identified the Mobile Telecommunications Sourcing Act—I think that was you, Mr. Hellerstein—as the poster child highlighting the appropriate role for Congress to address certain complexities that surface in State and local taxation of interstate commerce.

Do you see the need—same need, I should say, for Congress to set forth a similar framework for digital commerce?

Mr. HELLERSTEIN. Senator, I think that that would actually—that would fit within at least my view of what would be appropriate legislation. It is very important, again, to come back to Senator Hatch's point about, first, do no harm. It is very important that this be done surgically.

So, if we are to identify a particular State that may tax these goods and services and only that State, that, I think, is quite consistent with the Mobile Telecommunications Sourcing Act. On the other hand, as I read through this draft bill, I think it would be a field day for lawyers given the uncertainties with some of the definitions and the scope. So I would just urge this committee or whoever is considering this bill to be very, very careful in trying to do good, because there are provisions in the bill, as drafted, which I would regard as not ideal.

Senator THUNE. Does anybody else want to comment on that?

[No response.]

Senator THUNE. No. Let me ask just a question about this issue. If you had a consumer from Washington who is visiting Florida and downloads a song that is provided from a server in Utah, which State has the legal authority today to receive the tax revenue from that purchase?

Mr. HENCHMAN. They can all try, and that is the problem.

Senator THUNE. Yes. And without congressional action, is it not questionable as to which State, if any, has a right to receive the tax revenue from that transaction?

Mr. HENCHMAN. Absolutely, and they will all try.

Senator THUNE. Just as a question, too, I think you indicated State and local taxes should not impose an undue burden on interstate commerce.

Does it not make sense, then, if you agree that the purchase of downloaded music should be taxed no differently than the local purchase of a CD—I mean, if you are going to buy a CD in a store—that downloading music ought to be taxed in a similar way?

Mr. ZINMAN. Conceptually, that makes a lot of sense, yes. Administratively, it may be difficult to do, but conceptually, it makes a lot of sense.

Senator THUNE. But nobody basically disagrees with that concept? Conceptually, it makes sense?

The Digital Goods and Services Tax Fairness Act does not dictate whether or not a State can tax digital transactions, but rather sets a framework upon which State and local taxes can be applied to this form of commerce in a fair and rational manner.

Some have asserted there is no such impediment to a rational tax structure under existing law, citing the fact that consumers can get credits if they pay double taxes. However, would not all stakeholders be better served for Congress to establish some sort of framework that will provide the certainty for consumers, providers, and State and local governments in the taxes collected from digital commerce?

Mr. HENCHMAN. Yes.

Senator THUNE. Does anybody disagree with that?

Mr. HENCHMAN. The States will not do it themselves.

Senator THUNE. Thanks. Well, I guess the question is, how we do it. And we have a proposal out there and, hopefully, with your input, we can perhaps refine that and make it stronger and more effective. But certainly it is an area that I think needs to be addressed. And, with all the advances that we are seeing in technology and the way that people purchase various things these days, we are going to need some kind of a framework, and it seems, to me at least, that that is an issue that Congress is going to have to deal with.

So I thank you, Mr. Chairman. And thank you all for sharing your insights today.

The CHAIRMAN. Thank you, Senator.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. And let me thank the panelists.

I want to talk about one of the major sources of revenues for our States, and that is the sales and use tax.

Dr. Rueben, I want to focus on the fact of how much of those revenues are not being collected today. It has been estimated, as a result of out-of-State shipments, and principally through the Internet, that there is $11 billion a year not being collected.

Now, I got the Maryland number, and the Maryland number is $300 million, which is an interesting number, because the Governor is talking today about bringing the legislature back to a spe-

cial session in May because of a $300-million gap and is looking at increasing a lot of taxes in our State because we need $300 million to balance our budget.

If we had the sales and use tax, we would have a balanced budget and there would be no need to bring the legislature back into session, which brings me to the Marketplace Fairness Act and trying to establish a level playing field.

You can go to a retail store in Maryland, use your phone to take a photograph of its identification, then go on the Internet and get that product shipped into Maryland and avoid the sales tax. The price might be identical, but you are avoiding the sales tax. And to me, this is a matter of tax integrity.

That person who does that is supposed to pay a use tax. And I have heard that retailers or Internet sellers feel it is such a burden to have to collect a sales tax. It is a huge burden. They ask Marylanders to pay a use tax.

So are we not picking winners and losers if we do not take some action to provide for a level playing field?

Dr. RUEBEN. I am a big fan of there being some action to help coordinate these issues. I think that as more sales get done on the Internet or electronically or through catalogs, I think State and local governments are going to be at a disadvantage. And so congressional action to help coordinate this seems like a no-brainer, in my perspective.

Senator CARDIN. Thank you.

Mr. Zinman, I see that you are anxious to respond. I am going to give you a chance.

Mr. ZINMAN. I am just agreeing.

Senator CARDIN. Well, good. Let me just pose the question. There are two issues that are usually raised by those who have asked for delay of Federal action. One is that it is a little complicated because of all the different sales and use taxes. I point out that there is free software available that would assist in the collection of this. And the other issue is a small business exemption, which is included, by the way, in the Marketplace Fairness Act.

I am not aware of any small business exemptions on the brick-and-mortar requirements to collect sales tax if you have a facility located in our State. Is there any administrative reason why we should not be moving forward on this?

Mr. ZINMAN. Absolutely not. If you look at what is happening with Best Buy, that is, even though they are multistate, they are brick-and-mortar, and they are hurting a lot because of the Internet sales because—I will give you a perfect example.

An individual can go to New York and buy a set of golf clubs, but he has a place in Florida. He buys an expensive set of golf clubs. He says, “Ship it to Florida.” No sales tax. It will cost him $30 to ship the golf clubs down to Florida.

Mr. HENCHMAN. And Florida has a very high sales tax.

Mr. ZINMAN. But he is not paying—he is supposed to pay—I am not saying what he is supposed to do. I am saying what actually happens. What actually happens is he is not reporting that sales tax in Florida.

Senator CARDIN. I have not checked Florida’s use taxes, but my guess is there are not many being filed by individual consumers.

Mr. ZINMAN. That is right. In New York, we have a line on our New York State return—and many States have a line on their tax return—asking the taxpayer to voluntarily compute and give back the sales tax they should have paid in the form of a use tax.

But you now take a State like Florida that does not even have an income tax form to report this. They have the use tax forms. They are there. They are available. But many people who have multistate residences—and I am just using New York and Florida as an example, because that is a corridor that a lot of people travel—a lot of individuals are ignoring the taxes that they have to pay.

Senator CARDIN. It is my understanding that—and we have a form in our State where you can include the use tax. So we have that in Maryland.

The $300-million number I gave you was a net number.

Mr. ZINMAN. Right.

Senator CARDIN. I do not know the exact amount of use taxes we collect from individual consumers, but it is miniscule.

Mr. ZINMAN. I am sure it is miniscule.

Mr. HENCHMAN. Very briefly, I just want to make sure the goal of simplification is not minimized here, because, while that retailer has to collect and does not get a de minimis threshold, they are only collecting one sales tax. Internet retailers would have to track and collect 9,600 across the country.

And, yes, there is software on the rates, but that software does not help you distinguish between all the sales tax holidays and all the different rates on different products.

Senator CARDIN. Are you telling me that computers cannot figure this out? I have my——

Mr. HENCHMAN. It is not computers. It is tracking the——

Senator CARDIN. I am amazed at what I can put into my iPad and get an answer to immediately. Are you trying to tell me that we do not have a computer program that can figure out this issue?

Mr. HENCHMAN. It is not a question of computer programming, but a question of tracking changes in legislative laws. And there is a lot of——

Senator CARDIN. And my iPad gets me the up-to-date information on traffic instantaneously. You are trying to tell me we do not have that technology available today?

Mr. HENCHMAN. I work at the Tax Foundation. We do our best to keep track of all State and local laws and changes, and it is difficult for us, and we are not running a business. We are a tax policy——

Senator CARDIN. I think you had better get a better program. I find this hard to understand that when you have governmental actions, which are very public actions, every time taxes are changed, that that cannot be done.

I am not minimizing the issues of simplicity. And we have been talking about this ever since I have been in Congress, which is 20-some years. This is being used as an excuse for inaction. It is not a problem that cannot be overcome.

Mr. HENCHMAN. To me, it is not an excuse for inaction. It is an excuse for the right kind of action. Some of the bills you mentioned have some very good——

Senator CARDIN. After 20-some years, do you not think it is time for some action?

Mr. HENCHMAN. I agree.

Senator CARDIN. Thank you. I appreciate your agreement.

Mr. HENCHMAN. Some of the bills have some very good simplification rules.

Senator CARDIN. Thank you, Mr. Chairman.

The CHAIRMAN. I like that. That is good. [Laughter.]

That is how you get information out. That is great.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

Mr. Chairman, in beginning, I want to commend you for what I think folks need to understand is really what is at issue with your agenda today. What you are essentially doing is giving us an opportunity to lay out the digital rules of the road, and the fact is, if you look over history, it has always been this way with the economy. When you have new technologies and new developments, you have to update the rules of the road. We did it for the railroads. All through time, we have had to do it.

So I want to commend you for the agenda, the way we are looking at these issues, and I am looking forward to working with you.

Senator Thune talked about one of our bipartisan bills and laid out the Digital Goods and Services Tax Fairness Act. And with Senator Snowe here, I thought what I would do is take a couple of minutes to talk about our other major bipartisan bill, the Wireless Tax Fairness Act.

Here is the reality, folks. Here is my smart phone. And what we are dealing with is, we have smart phones today and dumb tax policies, tax policies that have not kept up with the times.

So we all remember the days of the mobile phone, these big, old things, and essentially we have the same tax policies for smart phones. And smart phones, of course, are how millions of Americans access the Internet. They are really a lifeline for some of the folks with a modest income that the Urban Institute does a lot of wonderful work for.

So what Senator Snowe and I want to do is make sure that, for the next 5 years, these smart phones are not subject to what amounts to multiple and discriminatory taxes—multiple and discriminatory taxes on wireless communications.

And, if you look at the last few years and all the taxes that have been heaped on wireless technology, we now have many States with taxes above 20 percent, the national average over 16 percent.

So what I would like to do is, first, get on the record, Mr. Sammartino, we had the CBO analyze the tax implications of our legislation. Now, remember, this is a bill—what Senator Snowe and I are advocating is something that would be prospective. It is not something that looks back in time.

It is part of laying out the rules of the road for the digital economy for the future. And it is my understanding that CBO has said—in the most recent analysis of July 28th of 2011—that our legislation, in the words of CBO, would have no significant cost to the Federal Government. And then at page 2 of the analysis, CBO did not identify any costs as well to State, local, or tribal governments.

So here is an opportunity, as we move in the committee of jurisdiction for laying out these rules as they relate to the digital economy, to take a major step forward in something that is literally a lifeline for millions of Americans.

And I want to kind of trace the history from those big mobile phones to these wonderful smart phones that are carried by millions to access the net, and we can do it without any net cost to either the Federal Government or the State and local governmental authorities.

I would just like to get your confirmation that that is the latest analysis by CBO, that the bill that Senator Snowe and I are talking about will not generate new costs to either the Federal Government or the State and local authorities. Is that your understanding, Mr. Sammartino?

Mr. SAMMARTINO. That is my understanding, Senator.

Senator WYDEN. Then for you, Mr. Henchman, we have done a lot of work with you all at the Tax Foundation. Why don't you give me your thoughts—and we are certainly going to be talking about the Marketplace Fairness Act in the days ahead, having followed this since the days when I was a coauthor with Senator Sununu and Senator McCain of the Internet Nondiscrimination Act.

We have always tried to come to grips with how to handle a new emerging technology. Is not the heart of it trying to have policies that have the Federal Government, first of all, do no harm and to ensure that there are not multiple and discriminatory taxes that come about from these thousands of jurisdictions?

When I first listened to some of the issues surrounding the Marketplace Fairness Act, I looked out at these scores of taxing jurisdictions, more than 5,000 of them, and some of the stuff just defied common sense. You would have jurisdictions that might—I remember there was one that would treat a chocolate bar one way and a cookie another way.

Mr. HENCHMAN. Right.

Senator WYDEN. Are these not some of the issues that we are going to have to deal with as we try in this committee to write these digital rules of the road?

Mr. HENCHMAN. Correct. And, as I specified, it is important that simplification be kept in mind, because right now we are up to 9,600 sales tax jurisdictions, growing by a couple hundred a year. We added 400 last year.

So we are moving away from uniformity and away from simplification in terms of number of rates, definitions, and how complex it is, and there are a lot of things Congress could lay out. And as I mentioned, some of the bills offer some very promising simplification options.

Senator WYDEN. My time has expired, Mr. Chairman. But, again, I want to thank you, and I hope people understand what is really at issue here, and that is, you are updating what are essentially the rules for the modern economy, the economy where the jobs are, and I really appreciate your leadership.

The CHAIRMAN. Thank you, Senator. You are pushing us in that direction too, and we deeply appreciate it.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman. Thank you for holding this hearing. And I, too, want to underscore what Senator Wyden has indicated with respect to this double taxation and, also, on the whole issue of wireless technology.

It has a disproportionate impact on low-income households, not to mention defeating our Federal policy of trying to make broadband ubiquitous. And so I think, for all those reasons, I would hope that we could pass this legislation, because it is undeniable that wireless is playing a very critical role for more than 300 million subscribers to wireless, not to mention to our economy.

I would like to get to the broader issue of tax reform. Because as I see it, comparing it to the past when we last engaged in tax reform in the U.S. Congress—which, as you know, culminated in the passage of the Tax Reform Act of 1986—believe it or not, it was 2 weeks before mid-term elections. It seems virtually impossible in today's political environment, regrettably.

I commend the chairman for holding a host of hearings on this issue. I just would hope that ultimately we move beyond the issue of discussing overall tax reform to making it a more concrete goal rather than a theoretical goal, because ultimately, if you look at the scope and the entirety of the issues that we are facing in this country with respect to the economy, it is subpar economic growth. It is the worst post-recession recovery in the history of our country.

There are two central issues. They are taxes and regulations, and providing certainty—certainty to consumers, certainty to businesses, but, also, certainty to State and local governments.

Think about the range of issues that keeps State and local governments in turmoil, between the failure to pass appropriations and budgets on time to the fact that we have an uncertainty with respect to the tax code, the disparate issues that affect the economy, and tax policy changes from State to State.

So I would like to ask the panelists—you, Mr. Henchman, about the whole question of tax reform. If Congress could deal with it, when should it happen and how should it happen? And is that not preferable? I mean, we are talking about a lot of different important issues.

But, if we start piecemealing our approach, it really is going to preempt the overall necessity of overhauling the tax code that has had more than 15,000 changes since 1986.

Mr. HENCHMAN. The template of 1986, I think, is the best one that you can go off of. I work mostly in State policy and, generally, bolder plans have more success than piecemeal approaches, because, when you are just parceling out one or two deductions to eliminate, the beneficiaries of those deductions can concentrate and preserve them and then you end up with nothing at all.

Maryland, a few years ago, looked to broaden its sales tax. It selected a handful of items to broaden it to. The beneficiaries of those descended on Annapolis, and eventually it turned into a tax on the one thing that had no lobbyists in Annapolis—a tax on computer services. Then they hired lobbyists and got that taken out, and Maryland ended up with nothing at the end of the day.

So I do not think that approach works. I think a 1986 approach is better—broader, comprehensive. And rather than saying, "Well, should we get rid of this deduction," look at it from the other per-

spective. Start from a blank slate and say, “What is justifiable? What should be included? What is the best way to do it through a tax deduction as opposed to through some other way?”

Senator SNOWE. Would anybody else care to comment? Dr. Rueben?

Dr. RUEBEN. I would just say that we should have something that has certainty in it, getting rid of a lot of the temporary provisions. I know it is costly if you are undertaking reform and you have to pay for things, but I think, from the State perspective, the fact that we are doing tax reform, and we are doing tax policy, through 1- or 2-year extensions is a problem. So anything that could make it more permanent rather than having things expire would be useful.

Senator SNOWE. Well, it is interesting, because one witness who testified before this committee in a recent hearing described our tax code as a permanent temporary tax code. And I think that that is very realistic and true, and I think that that is having a tremendous effect on the private sector, for example, in trying to create jobs, to invest in capital equipment, on consumers to make decisions, and, certainly, even on State and local governments having to make up the difference and the pressures on their own budgets.

So I think that that is the ultimate imperative, frankly, and one that we need to grapple with sooner rather than later, because ultimately I do not think we are going to see the kind of economic recovery that we deserve in this country and most certainly what the American people deserve.

Thank you.

The CHAIRMAN. Thank you, Senator. You make an excellent point. But I must remind all of us that none of this is easy. It is going to require some hard, tough decisions.

Since 1986, there are 15,000 changes to the code—15,000. In 1986, with tax reform, there were no extenders. Today, we have about 142, something like that; that is, provisions in the code which are temporary. They last for a year, 18 months, et cetera.

And I agree with the theory, and I am going to push hard to practice it, that is: deal with these provisions, make them either permanent or repeal them. Because you are right, Senator: uncertainty is one of the biggest impediments to growth in this country today, in my judgment, and the code certainly adds to that uncertainty.

But, if we are going to make it more certain, we are going to have to make some tough choices, very tough choices. And that really means just, to a larger degree, interest groups are going to have to subsume their narrow interests and try to come up with some alternative that makes a little more sense for the greater good.

The degree to which groups do that, the more likely it is we are going to achieve our desired result here. But, if they do not, with the narrow special interest politics in this country these days, it is going to be extremely difficult to achieve the goal that we all are pursuing.

So I just call on us all to be ready to bite the bullet and to come up with constructive alternatives. You cannot beat something with

nothing. Come up with an alternative that might make a little more sense as we work better together.

It really depends on the degree to which this country comes together and the degree to which people that we work for—we are just hired hands. We are just employees. It depends a lot on how much our employers really themselves want to come up with a constructive solution to this problem.

But you are right, Senator. I could not agree more. It is going to be difficult.

Senator Hatch?

Senator HATCH. Thank you, again, Mr. Chairman.

Mr. Hellerstein, in your testimony, you stressed the importance of adhering to a standard where income taxes are paid by those who work or live in a jurisdiction. You also discuss the example of a semi-professional soccer player who, though earning a small sum of money, nonetheless was obliged or obligated to file tax returns in many States.

In fact, I know this committee used to employ a professional minor league baseball umpire who was required to file returns in multiple States. And I am interested in your analysis of how States have, over the past few years, become increasingly aggressive in pursuing taxes from non-residents and how new sources of information have become available in States to facilitate their search for revenues.

Now, when did this trend originate, and how long has it been going on? And do you see it increasing in the future?

Then, finally, Mr. Zinman, if you could answer how you have witnessed States become more aggressive in their search for revenues and how this has impacted your clients. Do you think your clients are able to make residency decisions with full knowledge of the tax implications of their decisions, or does the complexity of State tax laws make that difficult?

So, if I could have you first, Mr. Hellerstein, and then Mr. Zinman.

Mr. HELLERSTEIN. Thank you, Senator. With all due respect, I believe it was not my testimony. Presumably, it was Mr. Zinman who referred to the soccer player. But I am familiar with the problem of taxing professional athletes, and, more generally—insofar as my testimony did address the problem of personal income taxation with regard to the role that Congress may play, and, indeed, this is an issue that I have testified about before in the House—I believe that Congress has a positive role to play here, at least with regard to employees who are temporarily in a State.

It seems to me both a burden on the employee, not to mention on the employer, who has to track 2 or 3 days of work in whatever State the employees go to. To provide a uniform standard under which employers have certainty and employees have certainty as to when they have an obligation, with some threshold—I do not know whether it should be 30 days or 40 days—I think is an appropriate thing to do, particularly because, like academic disputes, there is so little at stake, because to be sure, there are five States that do not have income taxes and, for the most part, we are just talking about which State gets the revenue. It is not like the revenue is going up in smoke.

But I believe Mr. Zinman may have more colorful examples than I do.

Senator HATCH. Mr. Zinman?

Mr. ZINMAN. Thank you, Senator.

First, let us talk about the problems that we have if we are an employee. Employees in various States, if they work in various States—and that is happening a great deal now—they get taxed in those States as non-residents. However, States have certain regulations on how the employers are supposed to report the information, and who is an employee and who is not an employee varies from State to State.

It becomes very difficult for an employee to report his information. I had a client this year who was a part-year resident of North Carolina and a part-year resident of New York. New York regulations require, whether you are a part-year resident, a non-resident, or a full-year resident, to report 100 percent of your earnings on your W–2 form in New York, and then the tax preparer or yourself, if you have to, allocates out based on the days, which is not always correct. So there are a lot of issues that happen.

Now, as far as the residency decision is concerned, besides family and quality of life, the tax rules do matter to a lot of people. A lot of people have moved to Florida because of estate tax issues, because of income tax issues, and a lot of people have moved to a State like Florida—and this also happens out in the West. They move to States that are tax-friendly, especially with estate tax issues, and they go there, one, because of quality of life and, two, because they can then give more of their estate to their children.

So these issues do become important. And what becomes even more important is that, if you do not do it right, your previous State where you resided is going to try to grab some of your assets anyway.

There are a lot of issues about people who reside in two different States and each State trying to claim that that person was a resident, and that does impact Federal law also. There was just recently a Tax Court decision in *Brown* where a husband and wife were New York and South Carolina residents, and New York had an audit and declared that their capital gains were New York capital gains. They agreed. They paid New York. They paid New York the deficiency. They paid penalties and interest, and they claimed the credit in South Carolina. The Federal law did not want to allocate the interest expense and the interest income the same way. So there was a problem, and the Browns actually, in Federal law, lost a little bit of extra money.

So where you are a resident and how the States look at that residency and how much they go after, that is very important to what the decisions are.

Senator HATCH. Well, thank you. The more I listen to you, I just am very grateful that I am just a humble attorney rather than a CPA. [Laughter.]

Mr. ZINMAN. We have a lot of fun doing this stuff.

Senator HATCH. I will bet you do.

Let me just end with this. Mr. Sammartino, I noticed in President Obama's fiscal year 2013 budget that the President's proposal for Build America Bonds resulted in an increase in outlays of $70

billion, as well as an increase in taxes of $63 billion, according to the Joint Committee on Taxation.

Outlays are defined as spending under the Congressional Budget Act. Therefore, the President's Build America Bonds proposal would increase spending by $70 billion and would increase taxes by $63 billion. Now, this would naturally increase the size of the Federal Government by at least $63 billion, as I view it.

Now, do you agree that the President's proposal increases spending by $70 billion and that it increases revenues by $63 billion? And do you agree that outlays are spending?

Mr. SAMMARTINO. Yes. Those were the numbers that JCT estimated for the proposal, that outlays would go up by $70 billion over 10 years and revenues from the reduction in deductible State and local taxes would increase by $63 billion.

CBO agrees that outlays for Build America Bonds are spending, but we also recognize that many economists would say that it is not clear whether higher revenues from a reduction in the tax expenditure for State and local interest is really a tax increase or a spending reduction, even though it is scored on the tax side of the budget.

But, yes, those were the numbers reported in our analysis of the President's budget.

Senator HATCH [presiding]. Well, thank you. I appreciate that.

I just want to mention, before we close down shop here, that Senator Enzi would have been here, but he is ranking member on the Health, Education, Labor, and Pensions Committee that I have been going back and forth to, and he wants to be excused, as he should be, because he is the ranking member there and has had to be in that markup this whole morning. So we will make excuses for him. And he is one of the more active members of this committee, and I just want to make that very clear.

We are really appreciative of your testimony. There are so many other issues that could be raised, but we appreciate the testimony. We appreciate the statements that you have put in writing. We read those, and, frankly, this has been a very good panel.

I just want to thank all of you for being here. And with that, we will recess until further notice.

[Whereupon, at 11:40 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Tax Reform and State and Local Tax and Fiscal Policy
As prepared for delivery

In Federalist Paper Number 41, James Madison wrote that one of the powers conferred on the Federal government is the "maintenance of harmony and proper intercourse among the states."

When Madison and our founders crafted the Constitution, they debated the proper division of power between the federal and state governments. Today we examine this question when it comes to the tax code.

Most state governments are in tough financial shape. In 2010, 48 states had budget shortfalls. All states except one are required by state law to balance their budgets. That has forced states to make tough decisions, such as raising taxes or cutting spending. Since the financial crisis, 46 states have cut services and 30 states have raised taxes.

To help states and local governments balance their budgets, the federal government provides direct support through programs like Medicaid. Thirty-six percent of all state revenues come from federal grant programs.

The federal government has also long played an indirect role boosting state and local governments through the tax code. Since the first income tax law, Congress has exempted interest on state and local bonds. This exemption helps cover part of the borrowing cost of projects by state and local governments.

The same is true for the state and local taxes. Since 1913, Congress has allowed some or all state and local income, general sales, excise and real and personal property taxes to be deducted from income for federal income tax purposes. These tax exemptions and deductions total more than twice what the Federal government provides to states in highway funding. Combined, they cost more than $105 billion per year.

During hard economic times, this federal support helps cushion the blow on state and local finances. It also ensures that state and local governments play a role deciding how some federal dollars are spent. For example, making the interest on bonds tax-exempt reduces the interest rate state and local governments pay to finance roads, schools, hospitals and other construction projects.

Just this February, voters in Manhattan, Montana approved new bonds so the community can afford to repair the Manhattan Elementary School's roof. Likewise, the deduction for state and local taxes reduces the burden that a state or local government places on its own residents in raising revenue.

As we reform the tax code to encourage growth and make our country more competitive, we need to ask whether the current exemptions and deductions make sense. State and local taxes could potentially be allowed as above-the-line deductions, allowing all taxpayers to benefit.

We could also consider providing a uniform subsidy for bond holders. Tax-exempt bonds subsidize interest paid on such bonds by exempting the interest from tax. Currently, the value of this subsidy varies based on taxpayers' marginal income tax rates. For every dollar we spend on infrastructure through a tax exempt bond, twenty cents goes to tax breaks for higher-income taxpayers. A uniform subsidy would mean each taxpayer receives the same subsidy regardless of tax bracket.

The Build America Bonds program achieved success using this approach. In Montana, the Barrett Hospital in Dillon was outdated and in need of constant repair. Dillon issued $30 million of insured Build America Bonds at a 3.67 percent interest rate. This reduced the borrowing cost to Dillon residents by a full percentage point, saving them more than $800,000. The project created 33 full-time jobs. Dillon now has a new, state-of-the-art, critical-access hospital.

Beyond these provisions in current law, we should also ask what else we can be doing to efficiently help state and local governments maintain sustainable budgets.

We need to make sure our federal, state and local tax systems are working together. As part of tax reform, we should ask how we can help states collect taxes owed and how we can encourage standard rules to protect taxpayers from multiple taxes and needless complexity.

We've worked together with the states to simplify rules in the past. Originally driven by the states, the International Fuel Tax Agreement provides a uniform system for the administration and reporting of fuel taxes paid by commercial trucks and buses operating in multiple states. States agreed to simplified administration burdens in exchange for the ability to enforce fuel use taxes. More recently, Congress enacted the Mobile Telecommunications Sourcing Act to establish uniform rules on which states can tax mobile calls. We should consider how we can learn from these examples to simplify the code.

So as we work to reform the tax code, let us remember the lessons from Madison and our founders. Let us bear in mind the relationship between our federal tax code and state and local tax systems. Let us improve the tax code to create growth and make the U.S. more competitive. And let us do this in a way that improves federal, state and local budgets.

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Senator Maria Cantwell
Finance Committee Hearing on
Tax Reform: What It Means for State and Local Tax and Fiscal Policy
April 25, 2012

Mr. Chairman, thank you for holding this hearing. The federal tax policy has a direct impact on state and local tax and fiscal policy; as a result, it is important that we understand the impact that making changes at the federal level can have at the state level.

In this time of economic uncertainty, it is especially important to make sure our constituents can depend on consistent, predictable deductions that they can plan around. It is also a matter of fairness and of particular importance to me and Washington state is the state and local sales tax deduction.

The deductibility of state and local taxes on federal income tax returns is permanent. However, states like mine have to fight every year to extend the sales tax deduction.

Many of you have argued that the ability to deduct state taxes acts as an indirect subsidy to state and local governments by offsetting the cost to taxpayers. State and local governments who can count on the ability of its taxpayers to deduct state income taxes receive a larger benefit than state governments, like Washington state, which finances its spending by other taxes such as the sales tax, which is not deductible on a permanent basis.

The sales tax deduction was taken away in 1986, and it wasn't restored until 2004. It has been extended every year since and it's time to just make it permanent. The 22 percent of Americans who claim the state and local sales tax deduction shouldn't be held captive once again. The value of the deduction varies depending on individual filing status and tax rate, but for Washington state, the $1.8 billion in deductions translated into $500 million or more staying in the Washington state economy, which puts an average of $500 back in Washingtonians' pockets.

Individuals living in places with state income tax are not faced with these same challenges. The deduction for state income tax is a permanent. This disparity unfairly punishes my Washington constituents as well as the taxpayers of Alaska, Florida, Nevada, South Dakota, Tennessee, Texas, and Wyoming.

Extending and making this deduction permanent are matters of tax fairness. And until we address the pros and cons of the ability to deduct all state and local taxes, the citizens of my state and the eight other states with no income tax deserve the same permanent treatment.

Congress cannot continue to leave taxpayers hanging, uncertain if their tax benefits would be restored by the time they have to file their taxes. We must extend this provision now. Most taxpayers work in good faith to comply with the law and pay their taxes. Congress should, at the very least, minimize the uncertainty that goes along with this annual obligation.

Additionally, another key federal tax policy impacting states is the treatment of tax-exempt bonds. The federal government provides preferential tax treatment for bonds, which in turn allows state and local governments to borrow more cheaply than they otherwise could. Tax-exempt bonds provide federal assistance to state and localities to subsidize state and local infrastructure such as roads, schools and other public goods as well as certain qualifying private projects.

Since 1991, tax-exempt bonds have become a more important source of financing, particularly for public investment in transportation facilities, such as highways, and private investment in education.

Over the period 2002 through 2011, State and Local governments have issued on average $384 billion in tax-exempt bonds. These tax-exempt bonds finance projects such as the Highway 520 Bridge in Washington state. It is important that we have efficient and effective ways to finance large infrastructure projects that promote economic growth.

Tax-exempt bond financing is helping us do that. I agree that it is important that we reform our tax code. However, I believe it is equally important to examine the potential economic impacts changing that would result from changing some of these policies.

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Statement for the Senate Finance Committee Hearing:
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
U.S. Senator Michael B. Enzi
April 25, 2012

Mr. Chairman, thank you for holding this hearing focusing on how tax reform could possibly affect state and local tax and fiscal policy. I truly appreciate yours and Senator Hatch's interest in hosting this hearing today. and allowing an open discussion in this Committee about the merits of my bill, S. 1832, The Marketplace Fairness Act.

The Marketplace Fairness Act was written in the aftermath of the Supreme Court's 1992 *Quill* decision. Congressional involvement is necessary because the ruling stated that the thousands of different state and local sales tax rules were too complicated and onerous to require businesses to collect sales taxes unless they had a physical presence (store, warehouse, etc.) in the purchaser's home state. The Supreme Court essentially "invited" the Congress to decide how to move forward.

I strongly believe that now is the time for Congress to act. Many Americans do not realize that when they buy something online or order something from a catalog from a business outside of their own State that they still owe the State sales tax. For over a decade, Congress has been debating how to best allow states to collect sales taxes from online retailers in a way that puts Main Street businesses on a level playing field with online retailers. The Marketplace Fairness Act empowers states to make the decision themselves. If they choose to collect already existing sales taxes on all purchases, regardless of whether the sale was online or in store, they can. If they want to keep things the way they are, it's a state's choice.

I have been working on this sales tax fairness issue since joining the U.S. Senate in 1997. As a former small business owner, it is important to level the playing field for all retailers – in-store, catalog, and online – so an outdated rule for sales tax collection does not adversely impact small businesses and Main Street retailers. On November 9, 2011, Senator Durbin, Senator Alexander, Senator Tim Johnson and I introduced – with six of our other colleagues - the Marketplace Fairness Act to close the 20-year loophole that distorts the American marketplace by picking winners and losers, by subsidizing some businesses at the expense of other businesses, and subsidizing taxpayers at the expense of other taxpayers. All businesses and their retail sales *and* all consumers and their purchases should be treated equally.

I want to provide you with some highlights of what the Marketplace Fairness Act accomplishes:

- The bill gives states the right to decide to collect – or not to collect – taxes that are already owed.

- The legislation would streamline the country's more than 9,000 diverse sales tax jurisdictions and provide two options by which states could begin collecting sales taxes from online and catalog purchases.
- The bill gives states two voluntary options that would allow them to collect the state sales taxes that are already owed if they choose. The first option is the Streamlined Sales and Use Tax Agreement, which is supported by 24 states that have already passed laws to simplify their sales tax collection rules. The second option puts in place basic minimum simplification measures states can adopt to make it easier for out-of-state businesses to comply.
- The bill also carves out small businesses so that they are not adversely affected by the new law by exempting businesses with less than $500,000 in online or out-of-state sales from collection requirements. This small business exemption will protect small merchants and give new businesses time to get started.

Do not let the critics get away with saying this kind of simplification cannot be done. In the early 1990s when the Quill decision was handed down, the Internet was still in diapers and cell phones came with bags and looked like bricks. Cell phones, software, computers, technology have all advanced at an exponential pace. The different rates and jurisdiction problem is no problem for today's programs.

As a former mayor and state legislator, I strongly favor giving states the authority to require sales and use tax collection from retailers on all sales if they choose to do so. Sales taxes go directly to state and local governments, which brings in needed revenue for maintaining our schools, fixing our roads and supporting local law enforcement. If sales over the Internet continue to go untaxed and electronic commerce continues to soar, revenues to state and local governments will plummet.

My legislation would help both consumers and states by reducing the burden on consumers and providing a mechanism that would allow states to systematically and fairly collect the taxes already owed to them. At a time when states are increasingly turning to the federal government for program funding, it makes sense for Congress to authorize states to collect taxes that are already owed. . The states' dependency on federal dollars could be offset by collecting taxes that are already owed from everyone who owes them at the state level. But if Congress fails to authorize states to collect tax on remote sales, and electronic commerce continues to grow, we are implicitly blessing a situation where states will be forced to raise other taxes B such as income or property taxes B to offset the growing loss of sales tax revenue. I want to avoid that. That is why we need to implement a plan that will allow states to generate revenue using mechanisms already approved by their local leaders. We need to allow states the ability to collect the sales taxes that are already on the books – which if enacted, it is estimated to provide $23 billion in fiscal relief in the 2012 alone for the states for which Congress does not have to find an offset.

This will give states less of an excuse to come knocking on the federal door for handouts and will reduce the problem of federally attached strings.

The Marketplace Fairness Act is not about new taxes. No one should tax the use of the Internet. No one should tax Internet services. I do, however, have concerns about using the Internet as a sales tax loophole. Sales tax collection is already required by my home state of Wyoming no matter how or where we buy something if it is not taxed by the state we get it from. Under Wyoming law, online purchases are already subject to sales tax – it is just not being collected or given to our state. The situation is very similar to that of other states.

Senators Durbin, Alexander, Tim Johnson, and I have worked tirelessly to assist sellers and state and local governments to simplify sales and use tax collection and administration. For the past several years, I have worked with all interested parties to find a mutually agreeable legislative package to introduce. Many hours have been dedicated to finding the right solution. I will continue to work with all interested parties to improve on the policy issues of concern to the stakeholders. Bill introduction does not stop us from negotiating and working together to improve the final product that should be enacted into public law.

The Marketplace Fairness Act is supported by over 200 organizations, including but not limited to the National Governors' Association, the National Conference of State Legislatures, the U.S. Conference of Mayors, National League of Cities, National Association of Counties, the National Retail Federation, and the Retail Industry Leaders Association. I would like to submit the entire list into the hearing record.

Ten years ago, the bills we considered to try to close this loophole were not adequate to solve the problem. The Marketplace Fairness Act does solve the problem. It is simple, it is about States' rights, and it is about fairness. At a time when State budgets are under increasing pressure, Congress should give State and local governments the ability to enforce their own laws. I strongly encourage my colleagues to support the Marketplace Fairness Act and get it enacted into public law this year.

Joint Statement

Senators Michael B Enzi, Richard J. Durbin, Lamar Alexander, Tim Johnson, John Boozman, Jack Reed, Roy Blunt, Sheldon Whitehouse, Bob Corker, and Mark Pryor

Tax Reform: What It Means for State and Local Tax and Fiscal Policy
April 25, 2012

For the past 20 years, states have been prohibited from enforcing their own sales and use tax laws on sales by out-of-state, catalog and online sellers due to the 1992 Supreme Court decision *Quill Corporation v. North Dakota*. Congress has been debating solutions for more than a decade, and some states have been forced to take action on their own, leading to greater confusion and further distorting the marketplace. Congressional action is necessary because the *Quill* ruling stated that the thousands of different state and local sales tax rules were too complicated and onerous to require businesses to collect sales taxes unless they have a physical presence in the state.

The Marketplace Fairness Act (S. 1832) would give states the right to decide for themselves whether to collect – or not to collect – sales and use taxes from out-of-state businesses that are already owed. The bill would not impose any new tax. This bipartisan legislation was introduced by five Republicans and five Democrats on November 9, 2011, and since then four cosponsors have been added. The legislation is supported by more than 200 business, government and labor organizations (see attached), including the National Governors Association, the National Conference of State Legislatures, the U.S. Conference of Mayors, National League of Cities, National Association of Counties, the National Retail Federation, the Retail Industry Leaders Association, and the largest online retailer, Amazon.com.

The Marketplace Fairness Act gives states two voluntary options that would allow states to collect sales taxes that are already owed if they choose. The first option is the Streamlined Sales and Use Tax Agreement, which is supported by twenty-four states that have passed laws to simplify their sales tax collection rules. The second option puts basic minimum simplification measures in place that states can adopt to make it easier for out-of-state businesses to comply.

Today, if an out-of-state retailer refuses to collect sales and use taxes, the burden is on the consumer, who is required to report the tax on his annual income tax return or a separate state tax form. However, most consumers are unaware of this legal requirement and very few comply with the law. Consumers can be audited and charged with penalties for failing to pay sales and use taxes. The Marketplace Fairness Act would eliminate such a burden on consumers.

Across the country, states and local governments are losing billions in tax revenue already owed. On average, states depend on sales and use taxes for 20 percent of their annual revenue. According to the National Conference of State Legislatures, this sales tax loophole will cost states and local governments $23 billion in avoided taxes in 2012. At a time when State budgets are under increasing pressure, Congress should act now to provide states the ability to enforce their own laws.

The *Quill* decision also put millions of local retailers at a competitive disadvantage by exempting remote retailers from tax collection responsibility. Local retailers in our communities are required to collect sales taxes, while online and catalog retailers selling in the same state are not required to collect any of these taxes. This creates a tax loophole that subsidizes some taxpayers at the expense of others and some businesses over others. The Marketplace Fairness Act would address and help close this loophole. Additionally, the bill would exempt businesses with less than $500,000 in annual online or out-of-state sales from collection requirements, which will protect small merchants and give new businesses time to get started.

State and local governments, retailers, and taxation experts from across the country are urging Congress to pass the Marketplace Fairness Act as soon as possible because it gives states the right to decide what works best for their local governments, residents, and businesses. The bill levels the playing field by allowing states to collect sales taxes from all retailers, regardless of their location. Given our fiscal constraints, we should allow states to enforce their own tax laws and make sure that state and local governments and businesses are not left behind in tax reform discussions.

We thank the Finance Committee for holding a hearing to discuss this important issue and we urge the Committee to quickly move forward and consider the Marketplace Fairness Act to provide states the ability to enforce their own tax laws and level the playing field for retailers.

Support for S. 1832, the Marketplace Fairness Act

American Federation of Labor and Congress of Industrial Organizations
Abbell Credit Corporation, Chicago, IL
Acadia Realty Trust, White Plains, NY
AFL-CIO Department for Professional Employees
Airgas, Inc.
Alabama College Bookstore Association
Alabama Retail Association
Alaska Veterinary Medical Association
Alliance of Wisconsin Retailers
Amazon.com
American Apparel and Footwear Association
American Booksellers Association
American Federation of State, County and Municipal Employees
American Federation of Teachers
American Specialty Toy Retailing Association
American Veterinary Medical Association
Arizona Retailers Association
Arkansas Grocers and Retail Merchants Association
Association for Christian Retail
Association of Washington Business
AutoZone, Inc.
Balliet's LLC
Barnes and Noble, Inc.
Beall's, Inc.
Bed, Bath, & Beyond, Inc.
Ben Bridge Jewelers, Seattle, WA
Best Buy Co., Inc.
Blake Hunt Ventures, Inc., Danville, CA
Build-A-Bear Workshop®, Saint Louis, MO
Buy.com
California Association of College Store
California Business Properties Association
California Retailers Association
California Veterinary Medical Association
Carolinas Food Industry Council
CBL & Associates Properties, Inc., Chattanooga, TN
Cencor Realty Services, Dallas, TX
Center on Budget and Policy Priorities
Certified Commercial Investment Member Institute
Chesterfield Blue Valley, LLC, St. Louis, MO
Christian Booksellers Association
City of Carrollton, Texas
College Stores of New England (MA, CT, RI, ME, VT, NH)
College Stores Association of New York State

College Stores Association of North Carolina
Colorado Retail Council
Colorado Veterinary Medical Association
Connecticut Retail Merchants Association
Consumer Electronics Association
Consumer Electronics Retailers Coalition
The Container Store, Dallas, Texas
The CortiGilchrist Partnership, llc, Al Corti, Principal, San Diego, CA
D. Talmage Hocker, The Hocker Group, Louisville, KY
David Hocker & Associates, Inc., Owensboro, Kentucky
DDR Corp., Beachwood, OH
Delaware Veterinary Medical Association
Dick's Sporting Goods, Inc.
DLC Management Corp., Tarrytown, NY
Donahue Schriber Realty Group, Costa Mesa, CA
Economic Alliance of Snohomish County, WA
Edens & Avant, Columbia, SC
Evergreen Devco, Inc., Glendale, CA
Fairfield Corporation, Battle Creek, MI
Federal Realty Investment Trust, Rockville, MD
FedTax, David Campbell, CEO
Florida Retail Federation
Food Marketing Institute
Foot Locker, Inc.
Footwear Distributors and Retailers of America
Forest City Enterprises, Inc., Cleveland, OH
Gap Inc., San Francisco, CA
Garrison Pacific Properties, San Rafael, CA
General Growth Properties, Chicago, IL
Georgia Association of College Stores
Georgia Retail Association
Georgia Veterinary Medical Association
Glimcher Realty Trust, Columbus, OH
Governing Board of the Streamlined Sales and Use Tax Agreement
Government Finance Officers Association
Great Lakes Independent Booksellers Association
The Greeby Companies, Inc., Chicago, IL
Hart Realty Advisers, Inc., Simsbury, CT
The Home Depot, Inc.
Hy-Vee, Inc.
Idaho Retailers Association
Idaho Veterinary Medical Association
Illinois Association of College Stores
Illinois Retail Merchants Association
Illinois State Veterinary Medical Association
Independent Running Retailer Association

Indiana Retail Council
Indiana Veterinary Medical Association
Institute of Real Management
International Association of Fire Fighters
International Council of Shopping Centers
International Economic Development Council
International Federation of Professional and Technical Engineers
Iowa Retail Federation
Iowa Veterinary Medical Association
J.C. Penney Corporation, Inc.
JCPenney
Jewelers of America
Jo-Ann Stores, Inc.
John Bucksbaum, Private Real Estate Investor/Developer, Former Chairman and CEO of General Growth
Kemper Development Company, Bellevue, WA
Kentucky Retail Federation
Kentucky Veterinary Medical Association
Kimco Realty Corporation, New Hyde Park, NY
The Kroger Company
L. Michael Foley and Associates, LLC, La Jolla, CA
Limited Brands, Inc.
Los Angeles Area Chamber of Commerce
Louisiana Retailers Association
Louisiana Veterinary Medical Association
Lowes Companies, Inc.
Maine Merchants Association
Maine Veterinary Medical Association
Malcolm Riley and Associates Los Angeles, CA
Marketing Developments, Inc. MI
Marshall Music Co., Lansing, MI
Mary Lou Fiala, CEO, Loft Unlimited, Ponte Vedra Beach Florida
Maryland Retailers Association
Massachusetts Veterinary Medical Association
Meijer, Inc.
Michigan Association of College Stores
Michigan Retailers Association
Michigan Veterinary Medical Association
Mid States Association of College Stores (IA, NE, KS, MO)
Middle Atlantic College Stores
Minnesota Retail Association
Minnesota Veterinary Medical Association
Missouri Retailers Association
Mountains and Plains Independent Booksellers Association
NAIOP, Commercial Real Estate Development Association
NAMM, National Association of Music Merchants

National Association of Chain Drug Stores
National Association of College Stores
National Association of Counties
National Association of Real Estate Investment Trusts
National Association of Realtors
National Bicycle Dealers Association
National Conference of State Legislatures
National Education Association
National Governors' Association
National Grocers Association
National Home Furnishings Association
National League of Cities
National Retail Federation
National School Supply and Equipment Association
Nebraska Retail Federation
Nebraska Veterinary Medical Association
The Neiman Marcus Group, Inc
Nevada Veterinary Medical Association
New Atlantic Independent Booksellers Association
New England Independent Booksellers Association
New Jersey Retail Merchants Association
New Jersey Veterinary Medical Association
New Mexico Retail Association
Newspaper Association of America
North American Retail Dealers Association
North Carolina Retail Merchants Association
North Carolina Veterinary Medical Association
North Dakota Retail Association
Northern California Independent Booksellers Association
Ohio Association of College Stores
Ohio Council of Retail Merchants
Oklahoma Veterinary Medical Association
Outdoor Industry Association
Pacific Northwest Booksellers Association
Pennsylvania Retailers' Association
Performance Marketing Association
Pet Industry Joint Advisory Council
Petco Animal Supplies, Inc.
PetSmart, Inc.
Planning Developments, Inc. MI
The Pratt Company, Mill Valley, CA
Professional Beauty Association
Properties, Inc., Chicago, IL
The Rappaport Companies, McLean, VA
Real Estate Roundtable
Realtors Land Institute

REI (Recreational Equipment, Inc.)
Reininga Corporation, Healdsburg, CA
Retail Association of Mississippi
Retail Association of Nevada
Retail Council of New York State
Retail Industry Leaders Association
Retail Merchants of Hawaii
Retailers Association of Massachusetts
Rhode Island Retail Federation
Rocky Mountain Skyline Bookstore Association (CO, MT, NM, WY)
Safeway, Inc.
Sears Holdings Corporation
Seattle Metropolitan Chamber of Commerce
The Seayco Group, Bentonville, AK
The Sembler Company, St. Petersburg, FL
Service Employees International Union
ShareASale
Simon Property Group, Indianapolis, IN
Soccer Dealer Association
Society of Industrial and Office Realtors
South Carolina Association of Veterinarians
South Carolina Retail Merchants Association
South Dakota Retailers Association
Southern Independent Booksellers Alliance
Southwest College Bookstore Association (AR, LA, TX, OK, NM, MS)
Steiner + Associates LLC, Columbus, Ohio
Stirling Properties, Covington, LA
Tanger Factory Outlet Centers, Inc., Greensboro, NC
Target Corporation
Taubman Realty Group, Bloomfield Hills, MI
Tennessee Retail Association
Tennessee Veterinary Medical Association
Texas Retailers Association
The Timberland Company
Tractor Supply Company
Tri-State Bookstore Association
The UAW
U.S. Conference of Mayors
Utah Food Industry Association
Utah Retail Merchants Association
Utah Veterinary Medical Association
Vermont Retail Association
Vestar Development Co. - Phoenix AZ
Virginia Retail Merchants Association
Virginia Veterinary Medical Association
Wal-Mart Stores, Bentonville, AR

Washington Retail Association
Washington State Veterinary Medical Association
WDP Partners, LLC, Phoenix, AZ
The Weitzman Group, Dallas, Texas
Wendy's Company
West Virginia Retailers Association
West Virginia Veterinary Medical Association
Western Development Corporation, Washington, DC
Westfield, LLC., Los Angeles, CA
Wisconsin Association of College Stores
Wisconsin Veterinary Medical Association
Wolfe Properties, LLC, St. Louis, MO
World Floor Covering Association
Wyoming Retail Association
Wyoming Veterinary Medical Association
Zumiez, Inc., Everett, WA

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF APRIL 25, 2012 TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining the impact of tax reform on state and local governments:

In reading the written testimony of our guests today, I was particularly struck by Mr. Hellerstein's recitation of the Hippocratic Oath — first, do no harm. Too often, Congress forgets this sensible advice. My hope is that this hearing, drawing on the wisdom of our five witnesses, will help Congress observe and honor Mr. Hellerstein's admonition.

The rush for new tax dollars that too often characterizes the federal legislative process, oftentimes leaves issues involving federal-state tax coordination by the wayside. But we cannot forget that the policies being discussed today touch-on fundamental constitutional principles of federalism and separation of powers. And if we are to do no harm it is important to hold hearings such as this one.

Though I do not have all the answers to the specific policy questions this hearing will wrestle with, I do have a series of bedrock principles that I believe will serve as a useful guide. The Tenth Amendment to our Constitution serves as the lodestar for today's hearing. As the testimony of our witnesses at least implicitly reminds us, under our Constitution of enumerated and limited federal powers, the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people. Issues involving the federal impact on state and local revenues impact both the Constitution's separation of powers between the federal and state governments and the separate identity of the sovereign states.

Too often, some view the Constitution and its limits on federal power as a hindrance to important objectives. I cannot subscribe to this approach. We all take an oath to protect and defend the Constitution. That Constitution, with its limits on federal power, is our greatest strength, not a weakness. And in walking the fine line between federal and state powers, we need to be especially mindful of our oath.

Federal discussions about state finances frequently highlight budgetary pressures that have required cuts in spending. These are no doubt difficult issues for states, but it simply is not the responsibility of the federal government to address state budget shortfalls. Some argue that the recent recession has uniquely harmed state revenues, somehow justifying the use of the federal government as a backstop. Yet as the Census Bureau noted in an April 12, 2012 report, state government tax collections in FY 2011 were actually up nearly 8 percent from the revenue collected in FY 2010. Something else is driving state budget shortfalls, and I think in many instances the principal issue for states is their own unsustainable spending.

Also, it is important to recall that the states are already receiving significant support from federal taxpayers. According to the Joint Committee on Taxation, federal deductions for

state and local taxes will diminish federal taxes by around $347 billion from 2011 to 2015. These deductions are generally regarded as helping states to leverage spending by minimizing the true cost of state and local government. As someone dedicated to states' rights, I believe that a state should be free to set its own tax and spending policies. But with rights come responsibilities. And state officials need to take responsibility for their own spending decisions.

In closing, I want to show my appreciation to the Members of this Committee who have a strong interest in these issues involving federal and state interaction. I know Senator Enzi has worked very hard for many years on what is now the Marketplace Fairness Act. Senator Thune and Senator Wyden have proposed the Digital Goods & Services Tax Fairness Act. Senators Snowe, Wyden, Menendez and Nelson are cosponsors of the Wireless Tax Fairness Act. Your work on these issues is a resource for all of us, and I look forward to continuing to work with all of you.

Thank you again Mr. Chairman. The work already done in this area, which is substantial, and the opportunities facilitated by this hearing, will help us ensure that when we go down the road of comprehensive tax reform we do no harm, and possibly even accomplish some good.

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Testimony of Walter Hellerstein
Francis Shackelford Professor of Taxation
Distinguished Research Professor
University of Georgia Law School

Before the
Committee on Finance
of the
United States Senate

Hearing on

Tax Reform:
What It Means for State and Local Tax and Fiscal Policy

Federal-State Tax Coordination:
What Congress Should or Should Not Do

April 25, 2012

I. INTRODUCTION

I am Walter Hellerstein, the Francis Shackelford Professor of Taxation and Distinguished Research Professor 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 federal consitutional and statutory restraints on state taxation of interstate commerce.

I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Committee my views on the implications of federal tax reform for state taxation and, in particular, the role of Congress in authorizing or limiting state taxation of interstate commerce. 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 provides an overview of federal-state tax coordination in an effort to assist this Committee in determining the appropriate role of Congress with regard to matters of state taxation.[1] By federal-state tax coordination, I mean both vertical tax coordination (coordination between concurrent federal and state tax regimes) and horizontal tax coordination (coordination among state tax regimes). If my testimony has an overriding theme, it may be best captured by Justice Holmes's wise observation that "a page of history is worth a volume of logic."[2] The historical record of federal-state tax coordination provides important lessons regarding the risks and rewards of such coordination and, consequently, guidance for evaluating current and future initiatives for such coordination.

Part II of this testimony considers our experience with vertical federal-state tax coordination in connection with concurrent federal and state taxation of wealth transfers and of income. Part III considers our experience with horizontal federal-state tax coordination in connection with federal efforts to harmonize or restrain state income, excise, and property taxes. Part IV examines pending congressional proposals for federal-state tax coordination. Part V concludes.

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[1]My testimony draws freely from "Federal-State Tax Coordination: The Good, the Bad, and the Ugly," a paper prepared for a conference on Federal Tax Reform Beyond the Beltway on February 3, 2012, sponsored by the UCLA Law School and the Tax Policy Center of the Urban Institute and the Brookings Institution. That paper, in turn, draws freely from my earlier work in this area, in particular, Hellerstein, Walter, "The United States," in Bizioli, Gianluigi, and Claudio Sacchetto, *Tax Aspects of Fiscal Federalism: A Comparative Analysis* (Amsterdam: IBFD, 2011), pp. 25-75; McLure, Charles E., Jr., and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," 31 *State Tax Notes* 9 (2004), pp. 721-35; Hellerstein, Walter, "Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce," 53 *National Tax Journal* 4, Part 3 (2000), pp. 1307-25; see generally Hellerstein, Jerome R, Walter Hellerstein, and John Swain, *State Taxation*, Vols. I and II (Valhalla: Thomson Reuters, 2012 rev.).

[2] *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

II. VERTICAL FEDERAL-STATE TAX COORDINATION: CONCURRENT TAX BASES

Historically, the federal government and the states have exercised their taxing powers concurrently over two tax bases: income (through both individual and corporate income taxes) and wealth transfers (through estate and gift taxes). Federal-state tax coordination (or the lack thereof) in both contexts illustrates both the promise and pitfalls of such tax coordination.

A. Wealth Transfer Taxes

1. *Historical Background*

Perhaps the most illuminating chapter in the history of federal-state tax coordination – and one that is still being written – involves the coordination of federal and state estate and inheritance taxes ("death taxes").[3] Death taxation has a long history in the United States at both the federal and state levels.[4] The federal government levied death taxes of various types at brief intervals beginning in the late eighteenth century (including the periods 1798-1802, 1861-70, and 1898-1902). Death taxes were likewise among the earliest levies employed by the states, beginning with Pennsylvania's inheritance tax in 1826, followed by similar taxes in Louisiana (1828), Virginia (1844), and Maryland, North Carolina, and Alabama shortly thereafter.[5] "By 1916, 43 of the (then) 48 states had adopted some form of inheritance tax and state spokesmen regarded the taxation of bequests as their 'special preserve.'"[6]

2. *The Federal Estate Tax of 1916 and the Adoption of the Credit for State Death Taxes*

In 1916, Congress enacted an estate tax that laid the foundation for federal and state death taxation for the next century. The primary motivating factor for the tax was the need to raise revenue in connection with World War I.[7] The U.S. Supreme Court sustained the levy as an "indirect" tax on the transfer of property at death over the objection that it was a "direct" tax

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[3] Inheritance taxes are taxes imposed on the right or privilege of receiving property measured by the share of the decedent's property transferred to the beneficiary. The tax rate often varies by reference to the closeness of the beneficiary's relationship to the decedent. Estate taxes, on the other hand, are taxes on the right or privilege of transferring property at death, measured by the value of the estate. The estate tax rate generally takes no account of the relationship of the recipient to the decedent. Indeed, the estate tax attaches before, and is independent of, the receipt of property by the legatee or distribute. See Hellerstein, Hellerstein, and Swain, *supra* note 1, at ¶ 21.02.

[4] See *id.* at ¶ 21.01, and U.S. Advisory Commission on Intergovernmental Relations, *Coordination of State and Federal Inheritance, Estate, and Gift Taxes* (Washington: U.S. Government Printing Office, 1961), on which the following historical description heavily relies.

[5] Oakes, Eugene E., "The Development of American State Death Taxes, 26 *Iowa Law Review* 3 (1941), pp. 451-78, at pp. 451, 453.

[6] U.S. Advisory Commission on Intergovernmental Relations, *supra* note 4, at p. 27.

[7] Wilbanks, Stephanie J., *Federal Taxation of Wealth Transfers – Cases and Problems* (New York: Aspen, 2004), p.5.

on property and therefore unconstitutional because it was not apportioned among the states by population.[8]

The enactment of the federal estate tax gave rise to intensified controversy over federal-state tax relations in the realm of death taxation, which had been the focus of attention for some time. A decade earlier, representatives of state interests vigorously opposed President Theodore Roosevelt's proposal for a federal inheritance tax. They contended that death taxes should be considered as lying exclusively within the states' domain, particularly in light of the states' long and consistent reliance on this source of revenue as contrasted with the federal government's sporadic reliance on such levies.

Following World War I, state spokesmen demanded that the federal estate tax be repealed, reiterating their position that death taxes should be the exclusive province of the states.[9] When Congress failed to respond immediately to these demands, a levy that was initially regarded as a temporary wartime measure became a lightning rod for debate over the proper role of federal and state governments in the field of estate and inheritance taxation, particularly in light of pressures on state legislatures to raise revenues. By 1922, every state but two (Florida and Alabama) had a death tax and controversy increased over the propriety of continuing the federal estate tax as a permanent part of the nation's tax structure.

As a short-term solution to this problem, Congress provided a 25 percent credit for state death taxes paid against the amount due under the federal estate tax, thereby effectively ceding one-quarter of the death tax base to the states. Pressure nevertheless continued for a complete withdrawal of the federal government from the death tax field and the continuing opposition to the federal estate tax culminated in two conferences in 1925 held under the auspices of the National Tax Association. These conferences resolved that the federal government should, in fact, withdraw from the death tax field within a six-year period and in the interim should increase the 25 percent credit to 80 percent.

There was, however, an additional issue – one of interstate tax competition – that played a role in the ultimate resolution of the issue of the federal-state tax coordination controversy, which illustrates how questions of horizontal tax coordination can affect the resolution of questions of vertical tax coordination. One of the objections of those who opposed repeal of the federal estate tax was that its elimination would lead to a "race to the bottom" among states in their competition to attract wealthy residents – a competition that would undermine the role of death taxes altogether as a significant source of state revenue. These fears were exacerbated by Florida's amendment of its constitution in 1924 to prohibit

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[8] *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921).

[9] Lowndes, Charles L.B., Robert Kramer, and John H. McCord, *Federal Estate and Gift Taxes* (St. Paul: West Publishing Co., 3d ed., 1974), p. 584.

inheritance taxation in an effort to lure residents from other states to locate (or at least retire) in Florida.[10] Those who were concerned about such interstate tax competition therefore urged the continuation of the federal estate tax, but with a credit for state death taxes to address the tax assignment issue.

The compromise that emerged from this controversy was the recognition, on the one hand, that the federal estate tax would be a permanent feature of the nation's tax structure, and, on the other hand, that the states had a legitimate claim to death tax revenues. The compromise was embodied in legislation in 1926 increasing the 25 percent credit for state death taxes paid (adopted two years earlier) to 80 percent of the amount due under the federal estate tax.[11] The legislation was generally viewed as serving two objectives. First, it represented a willingness of Congress to cede 80 percent of the death tax base to the states on a permanent basis and to reduce the aggregate federal-state tax burden on estates and inheritances. Second, the credit served the function of effectively providing a minimum state death tax regime that would deter interstate tax competition, because states would presumably be unable to resist the opportunity of enacting death taxes (at no tax cost to the their resident decedents or estate beneficiaries), because the state death tax would add no net tax burden as long as it did not exceed 80 percent of the federal tax burden.

3. *Federal-State Death Tax Coordination: 1926-2001*

The provision of the federal credit for state death taxes had a profound impact on federal-state tax coordination as 80 percent of the death tax base was allocated to the states and the states accommodated their death taxes to absorb the full amount of the credit that a taxpayer could claim under federal law. Indeed, for the balance of the twentieth century, the evolution of state death tax regimes reflected the states' increasing tendency to modify their statutes to adopt so-called "pickup" or "sponge" taxes designed to absorb the maximum federal estate tax credit and to eliminate estate or inheritance taxes independent of the pickup tax.[12]

During this period, Congress abandoned the 80/20 "tax base sharing" formula. In 1932, when Congress increased federal estate tax rates, it nevertheless froze the available credit for

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[10] Although Florida ultimately repealed this amendment in light of the developments discussed immediately below, it continues to attract residents from other states as a result of its constitutional prohibition on personal income taxation.

[11] See IRC § 2011.

[12] See Conway, Karen S., and Jonathan C. Rork, "Recent Developments in State 'Death' Taxes," 23 *State Tax Notes* 12 (2002), pp. 1041-45. The state death tax statutes designed to absorb the federal estate tax credit took various forms. Those states with preexisting death taxes typically imposed additional pickup taxes measured by the difference, if any, between the preexisting death tax liability and the maximum allowable federal estate tax credit. Such provisions accounted for the existence of two death taxes in a number of states. Other states adopted a single pickup tax measured by the federal estate tax credit and repealed preexisting state death taxes, if any.

state death taxes that was available under the lower 1926 rates. Congress continued this pattern with future changes in the federal estate tax rates, so that the available credit continued to reflect the 80 percent limitation based on 1926 rates and exemptions. Despite the modification of the original tax base allocation between federal and state governments, the basic pattern remained the same with the state statutes largely designed to absorb the maximum available federal tax credit.

In 2001, every one of 50 states had an estate tax that, in one form or another, was linked to the federal estate tax credit. Thirty-seven states and the District of Columbia imposed an estate tax that equaled the amount of the federal credit for state death taxes, and they imposed no other estate or inheritance tax independent of the levy designed to absorb federal estate tax credit.[13] The remaining 13 states imposed their own "independent" inheritance or estate taxes in conjunction with a residual pickup tax.[14] In these states, state laws specified that if the amount of the "independent" state death tax is less than the credit allowed against the federal estate tax, the state tax is increased to the full amount of the available credit. Three of these thirteen states were phasing out their separate taxes and were scheduled to rely exclusively on the pickup tax in the future.[15] In 2001, $6.4 billion (or 27 percent of the net federal estate tax revenue of $23.7 billion) was allocated to the states by virtue of the state death tax credit.[16]

4. *The Phase-Out of the Federal Estate Tax and the End of Federal-State Death Tax Coordination*

In 2001, as part of the tax cutting program of President George W. Bush, Congress repealed the federal estate tax (over a ten-year period), and, at the same time, eliminated the credit for state death taxes (over a four-year period).[17] Under the "sunset provisions" of the 2001 legislation, the estate tax was scheduled to reemerge, phoenix-like, in its pre-2002 form

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[13] McNichol, Elizabeth C., Iris J. Lav, and Daniel Tenny, "States Can Retain Their Estate Taxes Even as the Federal Estate Tax Is Phased Out," 23 *State Tax Notes* 8 (2002), pp. 673-91, at p. 676.

[14] *Id.*

[15] *Id.* at 677.

[16] Internal Revenue Service, Statistics of Income Division, "Estate Tax Returns Field for 2001 Decedents, by State of Residence" (Rev. Oct. 2007), available at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=210770,00.html.

[17] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. Law No. 107-16, 115 Stat. 38 (2001). The pre-2002 credit was reduced by 25 percent for estates of decedents dying during 2002, by 50 percent for estates of decedents dying during 2003, by 75 percent for estates of decedents dying during 2004, and it was eliminated for estates of decedents dying after 2004. *Id.* §§ 531, 532, 115 Stat. at 72-73. In place of the state death tax credit, Congress provided for a deduction of state death taxes from the value of the federal taxable estate. *Id.* §§ 531, 532, 115 Stat. at 73.

(including the credit for state death taxes).[18] In fact, in late 2010, Congress temporarily reinstated the federal estate tax through 2012.[19] The temporarily resurrected tax, however, was an emaciated rendition of the once robust levy. Whereas the pre-2002 version of the tax applied to estates in excess of $675,000 and at rates up 55 percent, the post-2010 version of the tax exempted all estates below $5 million with rates capped at 35 percent.[20]

The reduced profile of the revived federal estate tax was hardly surprising in light of existing anti-tax sentiment in the United States and particular animosity towards the federal "death tax."[21] More importantly for present purposes, however, Congress did *not* reinstate the credit for state death taxes in the 2010 legislation. Furthermore, it appears unlikely, given current federal revenue concerns, that the credit for state death taxes will be resuscitated in the future. It is therefore useful to discuss what is probably the final chapter in federal-state tax cooperation in the death tax field.

The reduction of the federal estate tax, and the repeal of the federal credit for state death taxes, had dramatic implications for federal-state tax coordination in the domain of death taxation. The actions at the federal level effectively eliminated the state pickup tax base in many instances. Unless states responded to these changes by severing the relationship between their death tax and the existence of the federal estate tax and the availability of a federal estate tax credit, they confronted a shrinking and, ultimately, disappearing death tax.

Of the 50 states that had some form of federally based death tax in 2001, 28 had no death tax at all by 2012, because their levies were inextricably linked to the existence of a federal levy and the federal death tax credit,[22] and they had taken no action to enact an "independent" death tax. Of the remaining 22 states with some form of death tax, many of these states' tax regimes were mere shadows of their former selves, because their residual pickup taxes had disappeared and they were left only with their relatively modest

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[18] *Id.* § 901, 115 Stat. at 150.

[19] In late 2010, Congress enacted (and the President signed) the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," P.L. 111-312, 124 Stat. 3296 (2010).

[20] *Id.* § 302.

[21] See Graetz, Michael J., and Ian Shapiro, *Death by a Thousand Cuts: The Fight Over Taxing Inherited Wealth* (Princeton: Princeton University Press, 2005).

[22] 2012 State Death Tax Chart (March 26, 2012) available at www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf; see also All States Tax Guide (RIA) ¶ 210 (chart of state taxes), available at www.checkpoint.thomsonreuters.com.

"independent" inheritance or estate taxes.[23] Consequently, as one observer noted, "[i]n an odd twist of fate," state death taxes "historically regarded as most appropriately a state-level tax, are quickly becoming an artifact of the past at the state level."[24] In short, if one is looking for a cautionary tale in the history of federal-state tax coordination in the United States, there is no better place to look than the death tax regime,[25] as it has variously embodied both the best and the worst of federal-state tax coordination at various junctures in our history.

B. Income Taxes

1. *Federal-State Tax Base Conformity*

As the U.S. Supreme Court has observed, "[c]oncurrent federal and state taxation of income ... is a well-established norm,"[26] and, "[a]bsent some explicit directive from Congress, we cannot infer that treatment of ... income at the federal level mandates identical treatment by the States."[27] In point of fact, there has never been any such "mandate," despite Congress's recognized power to require national and subnational uniformity.[28] Moreover, while Congress at one point offered to have the federal government administer state personal income taxes if the states would closely conform their taxes to the federal model, not a single state accepted the offer.[29] The law embodying the offer was ultimately repealed for lack of use.[30] This episode

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[23] See *id.* and *supra* note 14 and accompanying text. Moreover, in March 2012, Indiana adopted legislation phasing out its inheritance tax over nine years beginning in 2013 and ending on December 31, 2021. SB 293 (signed by Governor Daniels on March 20, 2012).

[24] Nutter, Sarah E., "State Estate, Inheritance, and Gift Taxes: Uncertainty at the Federal Level Passes Down to the States," 46 *State Tax Notes* 7 (2007), pp. 481-501, at p. 484. In fact, states' taxes on inherited wealth fell from 1.4% of their total tax receipts in 2000 to less than 0.6% in 2010. U.S. Census Bureau of the Census, *Annual Survey of State Government Tax Collections* (2000, 2010), available at http://www.census/gov/govs/statetax/index.html.

[25] Indeed, wholly apart from federal-state tax coordination, the uncertainty created at the federal level in light of Congress's peripatetic approach to the estate and gift tax is a cautionary tale worthy of study on its own. See Kaufman, Beth S., "The Federal Estate and Gift Tax: A Case Study in Uncertainty," 64 *National Tax Journal* 4 (2011), pp. 943-948.

[26] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 448 (1980).

[27] *Id.*

[28] Thus the U.S. Supreme Court has declared that "[i]t is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income." *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 280 (1978).

[29] Prior to its repeal, the Federal-State Tax Collection Act of 1972 (the FSTCA), 26 U.S.C. §§ 6361-65 (prior law), provided that a state with a "qualified State individual income tax" (i.e., a tax closely conforming to the federal model) could enter into an agreement with the United States to have its individual income taxes collected and administered by the federal government. Among other requirements, the qualifying state income tax had to adopt the federal income tax regulations "as in effect from time to time" under the Internal Revenue Code. *Id.* § 6362. As originally enacted, the FSTCA provided that it would not be effective until at least two states with collectively more than 5 percent of the federal tax returns had entered into an agreement under the statute. That requirement was

in the saga of federal-state tax coordination is a testament to deeply held beliefs about state sovereignty – and perhaps to the power of deeply entrenched state tax bureaucracies – that can impede intergovernmental tax coordination.

Despite the lack of any congressional mandate for state conformity to the federal income tax model, state personal and corporate income taxes in fact closely conform to the federal income tax. The pressure for conformity comes from "market" forces, namely, pressure from taxpayers for easing compliance and auditing burdens. At one time, some states adopted the most extreme form of federal conformity, under which the state tax was simply a percentage of the federal tax. Although no state embraces that method today, the overwhelming majority of states with broad-based income taxes employ federal adjusted gross income (personal income before personal exemptions or deductions) or federal taxable income as the computational starting point for determining state taxable income.

One of the consequences of having de facto conformity in federal and state income tax bases is that base-broadening or base-narrowing at the federal level tends to generate a response at the state level, because failure to respond ordinarily increases or decreases state tax revenues in the absence of a state rate adjustment. The Federal Tax Reform Act of 1986, for example, broadened the federal personal income tax while lowering its rates. Some deductions were eliminated, others were substantially limited, and the treatment of a variety of specific items was altered – all in the name of simplification in a revenue-neutral fashion (because federal rates were lowered). For the overwhelming majority of states whose tax bases were tied to the federal base but whose tax rates were independent of the federal rate structure, base-broadening at the federal level offered the prospect of substantial increases in tax revenues if the states did not lower their own rates as the federal government had done. In fact, 27 of the 40 states with broad-based personal income taxes enacted reforms during late 1986 and 1987,[31] with most of the states returning at least a portion of the so-called revenue "windfall" to state taxpayers.[32]

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eased by the 1976 Tax Reform Act to provide that the FSTCA would be effective on the first January 1 that was more than one year after at least one state entered into such an agreement. *Id.* The 1976 Tax Reform Act also made it clear that the federal collection plan was to be administered without added costs to the states – a provision that was adopted in response to suggestions that the states would or might be charged for the services provided by the federal government. Stoltz, Otto G., and George A., Purdy, "Federal Collection of State Individual Income Taxes," 1977 *Duke Law Journal* 1 (1977), pp. 59-141, at p. 92.

[30] The statute was repealed in 1990, eighteen years after its enactment.

[31] Gold, Steven D., "The Budding Revolution in State Income Taxes," *Proceedings of the Eightieth Annual Conference of the National Tax Association – Tax Institute of America* (1987), pp. 6-11, at p. 7. In 1991, Connecticut became the forty-first state to adopt a broad-based personal income tax.

[32] Hellerstein, Hellerstein, and Swain, *supra* note 1, at ¶ 20.02.

By contrast, when Congress narrows the federal tax base in order to stimulate the economy, it creates the opposite dilemma for the states. For example, Congress's post–September 11, 2001, economic stimulus package gave rise to conformity issues for the states. In the Job Creation and Worker Assistance Act of 2002, Congress provided for an additional first-year depreciation allowance to encourage investment. The impact of this so-called "bonus depreciation" on state revenues – assuming they took no action to decouple their tax regimes from the federal model – was substantial. Facing severe budget shortfalls even without the revenue impact of bonus depreciation, many states reacted by decoupling their tax regimes from the federal tax regime insofar as bonus depreciation was concerned. Some states enacted legislation completely decoupling from the bonus depreciation provisions, other states partially decoupled, and yet other states conformed to the federal rules. Needless to say, such lack of conformity between state and federal tax bases can create havoc for taxpayers and revenue administrations.[33]

2. *Tax "Concessions"*

There are several federal income tax provisions that reflect a sensitivity to the existence of concurrent taxation, and the concerns of federal-state tax coordination, even if they may more properly be characterized as unilateral tax "concessions" by the Congress rather than "coordination" of concurrent tax regimes. Among these are the deduction from the federal tax base for state income and property taxes and the exclusion from the federal income tax base of interest from state and local government bonds.

a. Deductibility of State and Local Taxes from the Federal Income Tax Base

State and local taxes have always been deductible, in whole or in part, from the federal income tax base, at least for those who itemized their deductions.[34] The deduction has been available whether or not such taxes were associated with the production of income, in which case the deduction would be appropriate as a matter of principle in arriving at the proper definition of taxable income. For this reason, such deductions (when not associated with the production of income) have generally been regarded as "tax expenditures" or subsidies that the federal government provides to the states. Accordingly, they may be regarded as form of revenue sharing. For fiscal year 2012, for example, the estimated fiscal significance of the deductions from federal income taxes for "nonbusiness" state and local government income taxes, sales taxes, and personal property taxes, which the tax expenditure budget characterizes

[33] See generally Luna, LeAnn, and Ann Boyd Watts, "Federal Tax Legislative Changes and State Conformity," 47 *State Tax Notes* 8 (2008), pp. 619-25

[34] Brazer, Harvey E., "The Deductibility of State and Local Taxes Under the Individual Income Tax," U.S. House Committee on Ways and Means, 86th Cong., 1st Sess., *Tax Revision Compendium*, Vol. I (Washington: U.S. Government Printing Office, 1959), p. 407. For taxpayers who take a "standard" deduction, there is no identification of the particular expenses associated with the deduction.

as "general purpose fiscal assistance," amounted to $51 billion.[35] The fiscal significance of the deduction for taxes on real property amounted to another $26.5 billion.[36]

Historically, virtually all state and local taxes were deductible from the federal income tax base.[37] Over the past half-century, however, the scope of the deduction has narrowed. In 1964, Congress altered the nature of the deduction from one generally permissible unless explicitly denied to one that was permitted only for taxes explicitly mentioned. It thereby eliminated the deduction for so-called "sin" taxes (excise taxes on alcohol and tobacco). In 1978, in the midst of an energy crisis, Congress eliminated the deduction for state gasoline taxes. The most significant change occurred as part of the Tax Reform Act of 1986, which eliminated the deduction for state and local sales taxes, as part of the general policy to broaden and simplify the federal tax base in a revenue neutral manner. In 2004, however, Congress reinstated the deduction for residents of states without income taxes. Currently, the most significant deductions are for state income and local real property taxes. There is an ongoing policy debate about whether the deduction for state income taxes should be eliminated.

b. Exclusion for Interest from State and Local Government Bonds

The other significant tax concession – with a "cost" to the federal government estimated at value of $23.1 billion for fiscal year 2012[38] – is the exclusion from federal income tax of interest from state and local government bonds.[39] Although for many years the immunity of state and local bond interest from federal taxation was thought to be constitutionally required,[40] with the narrowing of the scope of the intergovernmental tax immunity doctrine, this view was ultimately abandoned. In 1985, the U.S. Supreme Court explicitly overruled an earlier case holding that interest from state bonds was constitutionally immune from tax and declared that "a nondiscriminatory federal tax on the interest earned on state bonds does not

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[35] U.S. Senate Committee on Finance and US House Committee on Ways and Means, Joint Committee on Taxation, *Estimates of Tax Expenditures for Fiscal Years 2010-2014* (Washington: US Government Printing Office, 2010), p. 51.

[36] *Id.* at 39.

[37] See Maguire, Steven, *Federal Deductibility of State and Local Taxes* (Congressional Research Service Report for Congress 2007), p. 1, available at http://www.policyarchive.org/handle/10207/bitstreams/18802.pdf. A provision of the original income tax of 1913 allowed a deduction for "all ... State, county, school and municipal taxes ... not including those assessed against local benefits." *Id.* see also Oliver, Philip D., *Tax Policy* (New York: Foundation Press, 2nd ed., 2004), p. 839.

[38] U.S. Senate Committee on Finance and U.S. House Committee on Ways and Means, Joint Committee on Taxation, *Estimates of Tax Expenditures for Fiscal Years 2010-2014* (Washington: US Government Printing Office, 2010), p. 45.

[39] IRC § 103.

[40] See Hellerstein, *Tax Aspects of Fiscal Federalism*, *supra* note 1, at 35-37.

violate the intergovernmental tax immunity doctrine."[41] The exclusion of such interest from federal income taxation nevertheless survives as a matter of congressional legislation, which has embedded that principle in the Internal Revenue Code.

III. HORIZONTAL FEDERAL-STATE TAX COORDINATION

A. Overview

Although there have occasionally been proposals for broad-based federal legislation providing for horizontal state tax coordination, such as congressional bills providing for a uniform state corporate income tax apportionment formula,[42] no federal law providing for wide-ranging horizontal state tax coordination has ever been enacted. Instead, virtually the entire body of federal law addressed to horizontal state tax coordination has focused on narrow, industry-linked issues, often by limiting the states' power to tax in precisely defined contexts. Indeed, much of this legislation may more properly be characterized as prohibiting the exercise of state tax power, whether wisely or not, rather than "coordinating" it. For example, federal legislation

- forbids the states from taxing railroad, motor carrier, and air carrier property more heavily than other commercial and industrial property;[43]
- imposes limitations on the states' power to levy stock transfer taxes;[44]
- prohibits the states from imposing user charges in connection with the carriage of persons in air commerce;[45]
- "supersede[s] any and all State taxes insofar as they now or hereafter relate to any employee benefit plan" instituted pursuant to the Employee Retirement Income Security Act (ERISA);[46]
- prohibits the states from imposing electrical energy taxes discriminating against out-of-state purchasers;[47]

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[41] *South Carolina v. Baker*, 485 U.S. 505, 526 (1985).

[42] See Hellerstein, Hellerstein, and Swain, *supra* note 1, at ¶ 8.06 and sources there cited.

[43] 49 U.S.C. §11501 (2006) (railroads); 49 U.S.C. § 14502 (2006) (motor carriers); 49 U.S.C. § 40116 (2006) (air carriers).

[44] 15 U.S.C. § 78bb(d) (2006).

[45] 49 U.S.C. § 40116 (2006).

[46] 29 U.S.C. § 1144(a) (2006).

[47] 15 U.S.C. § 391 (2006).

- prohibits state and local governments from taxing flights of commercial aircraft or any activity or service aboard such aircraft unless the aircraft takes off or lands in the taxing jurisdiction;[48]
- prohibits localities from taxing providers of direct-to-home satellite services;[49]
- limits state and local franchise fees on cable operators;[50]
- prohibits a state, other than the state of the employee's residence, from taxing the employee's compensation from an interstate rail carrier, motor carrier, or merchant mariner;[51]
- limits the states' authority to require withholding of income taxes from certain employees of water carriers;[52]
- prohibits states from taxing interstate passenger transportation by motor carriers;[53] it imposes specified restraints on state taxation of transactions over the Internet;[54]
- authorizes, under specified conditions, state taxation of charges for mobile telecommunications services;[55]
- bars state taxes whose "purpose" is to provide "compensation for claims for any costs of response or damages or claims which may be compensated under [the "Superfund" Act]";[56] and
- prevents states from imposing income taxes on the "retirement income" of nonresidents.[57]

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[48] 49 U.S.C. § 40116(c) (2006).

[49] 47 U.S.C. § 251 (2006).

[50] 47 U.S.C. § 542 (2006).

[51] 49 U.S.C. § 11502 (2006) (railroad employees); 49 U.S.C. § 14503 (2006) (motor carrier employees); 46 U.S.C. § 11108(b) (2006) (merchant mariner employees).

[52] 46 U.S.C. § 11108(a) (2006).

[53] 49 U.S.C. § 14505 (2006).

[54] Internet Tax Freedom Act, Pub. L. No. 105–277, Div. C, Title XI, § 1104(3), 112 Stat. 2681 (1998) (as amended).

[55] 4 U.S.C. § 116 et seq. (2006).

[56] The Federal Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. § 9614(c) (2006) (commonly known as the "Superfund Act").

[57] 4 U.S.C. § 114 (2006). "Retirement income" is defined as income from qualified plans under the Internal Revenue Code as well as certain nonqualified plans that mirror qualified plans. *Id.* § 114(b)(1).

Even what is arguably the broadest piece of legislation that provides for federal-state tax coordination – the provision of a uniform jurisdictional threshold for taxation of income from interstate commerce – is limited to income from sales of tangible personal property, and thus excludes the increasingly important part of the economy that derives income from services and intangibles.[58]

If there is a leitmotif running through the federal legislation addressed to horizontal tax coordination (broadly conceived to include tax prohibitions), it is probably that the legislation typically constitutes a targeted response to a specific problem. For example, a number of the federal provisions were direct responses to U.S. Supreme Court decisions:

- The jurisdictional restraint on state taxation of income from interstate commerce derived from the sale of tangible personal property[59] was designed to confine the impact of *Northwestern States Portland Cement Co. v. Minnesota*,[60] which sustained the states' power to impose a fairly apportioned, nondiscriminatory tax on net income derived from interstate commerce.
- The prohibition on state taxation of interstate passenger transportation by motor carriers[61] was designed to overrule *Oklahoma Tax Commission v. Jefferson Lines, Inc.*,[62] which sustained an unapportioned tax on the sale of bus tickets for interstate transportation.
- The bar against states' imposition of user charges in connection with the carriage of persons in air commerce[63] was designed to overrule *Evansville-Vanderburgh Airport Authority District v. Delta Airlines, Inc.*,[64] which sustained the states' power to impose charges to recoup the costs of airport construction and maintenance.

In addition to legislation responding to specific court decisions, some of the legislation was addressed to specific abuses (or perceived abuses), such as the assessment of railroad and

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[58] 15 U.S.C. §§ 381-84 (2006).

[59] 15 U.S.C. §§ 381-84 (2006).

[60] 358 U.S. 450 (1959).

[61] 49 U.S.C. § 14505 (2006).

[62] 514 U.S. 175 (1995).

[63] 49 U.S.C. § 40116 (2006).

[64] 405 U.S. 707 (1972).

other transportation property at a higher percentage of fair market value than that applied to other commercial and industrial property. [65] Other provisions were designed to protect identifiable federal interests, such as federally authorized employee benefit plans[66] or the Outer Continental Shelf.[67] Still other provisions were intended to foster the development of particular economic activity, such as the use of the Internet.[68]

Whatever one's views may be as to the wisdom of such legislation,[69] the explanation for the existing universe of horizontal federal-state tax coordination lies largely in "history" rather than "logic," as suggested at the outset.[70]

B. A Review of the Record of Horizontal Federal-State Tax Coordination from a Policy and Practical Perspective

While the existing landscape of horizontal federal-state tax coordination may owe its features to history rather than logic, it is instructive to examine the results of these congressional forays into state taxation as an aid to determining "best practices" in this context. Although my examples are selective, I believe they illustrate what works and what does not work from a policy and practical perspective in the context of horizontal federal-state tax coordination.

1. *What Works Well: The Mobile Telecommunications Sourcing Act*

The Mobile Telecommunications Sourcing Act (MTSA)[71] enacted by Congress in 2000 is a poster child for horizontal federal-state tax coordination at its best. To understand why, one must first appreciate the constitutional rules governing state taxation of interstate telecommunications. Under jurisdictional standards that the U.S. Supreme Court articulated in *Goldberg v. Sweet*[72] under the dormant Commerce Clause, the "only" states with "a nexus

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[65] 49 U.S.C. §§ 11501, 14502 40116 (2006).

[66] 29 U.S.C. § 1114(a) (2006).

[67] 43 U.S.C. § 1333(a)(2) (2006).

[68] Internet Tax Freedom Act, Pub. L. No. 105–277, Div. C, Title XI, § 1104(3), 112 Stat. 2681 (1998) (as amended).

[69] Charles McLure and I have elsewhere set forth at some length our views as to the normative criteria that ought to govern the question of federal intervention in state taxation in the context of three proposals designed to achieve horizontal tax coordination McLure and Hellerstein, *supra* note 1. Some of these views are set forth in the ensuing discussion.

[70] See *supra* note 2 and accompanying text (quoting *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921) (Holmes, J.)).

[71] 114 Stat. 626 (July 28, 2000), codified at 4 U.S.C. § 116 et seq. (2006).

[72] 488 U.S. 252 (1989).

substantial enough to tax a consumer's purchase of an interstate telephone call" are (1) "a State ... which taxes the origination or termination of an interstate telephone call charged to a service address within that State" and (2) "a State which taxes the origination or termination of an interstate telephone call billed or paid within that State."[73] The implications of these standards for taxation of the wireless telecommunications industry are troublesome to say the least. Consider a business traveler who lives in State A, where she receives her monthly phone bill, and, while in State B on business, makes a call to State C. Under *Goldberg*, none of these states can tax the charges for the call, because none of them can claim that the call either originates or terminates in the state *and* is charged to a service address in the state or is billed or paid within the state.

The issues become even more complex if the customer is billed not on a transaction-by-transaction basis, but instead pays, say, $50 per month for 500 minutes of calls regardless of where the calls originate or terminate. Indeed, if the customer were billed at a flat rate, the *Goldberg*-mandated inquiry would be virtually impossible, since there would be no breakdown of the charges for the calls on a transaction-by-transaction basis. A typical wireless phone bill simply shows the calls made and the minutes consumed with no itemized price allocation if one does not exceed the number of flat rate minutes. Indeed, the "charge" shown for such individual calls is "$00.00."

The difficulties involved in taxing mobile telecommunications under the regime the Court established in *Goldberg* led Congress, with the joint support of the telecommunications industry and the states, to enact the MTSA, which permits the states to tax *all* mobile telecommunications charges (for services provided by the customer's "home service provider") at the customer's "place of primary use."[74] The key operative language of the MTSA, which *both* expands *and* contracts state power to tax charges for mobile telecommunications, provides:

> All charges for mobile telecommunications services that are deemed to be provided by the customer's home service provider ... are authorized to be subjected to tax, charge, or fee by the taxing jurisdictions whose territorial limits encompass the customer's place of primary use, regardless of where the mobile telecommunications services originate, terminate, or pass through, and no other jurisdiction may impose taxes, charges, or fees on charges for such mobile telecommunications services.[75]

The expansion of state power is provided by the grant of authority to the state of the customer's home service provider to tax the charge for wireless services regardless of whether that state possesses power to tax the call under the preexisting standards of *Goldberg v. Sweet*.

[73] *Id. at* 263.

[74] 4 U.S.C. § 116 et seq.

[75] *Id.* § 117(a).

The contraction of state power is contained in the final clause that prevents any state other than the state of the customer's home service provider from taxing such charges, even if that state possessed power under *Goldberg v. Sweet* to tax the charge.

The MTSA is a model for federal-state horizontal tax coordination. It judiciously employs Congress's power to both expand and restrain state tax power in a manner that allows taxes to be collected in a sensible manner and at the same time protects taxpayers from multiple taxation. It is thus a win-win solution for all concerned and constitutes a marked improvement over the state of play prior to the enactment of the legislation.[76]

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[76] An analogous model for federal-state tax coordination is reflected in Congress's endorsement of the International Fuel Tax Agreement (IFTA). IFTA had its origins in the difficulties that the states confronted in implementing their motor fuel taxes, which generally are viewed as user fees with revenues dedicated for transportation purposes. See generally Denison, Dwight, and Rex L. Facer, "Interstate Tax Coordination: Lessons from the International Fuel Tax Agreement," 58 *National Tax Journal* 3 (2005), pp. 591-603, on which much of the discussion of IFTA is based. For practical purposes, states have always allowed individual motorists to pay fuel taxes at the pump without attempting to determine the miles driven in a particular jurisdiction. However, states have traditionally attempted to enforce fuel taxes on large commercial motor carriers based on an apportionment of miles driven in a state. The trucking industry had generally been willing to cooperate in this effort because of the importance of highways (and highway funding) to the industry. Nevertheless, the complexities of system prior IFTA were daunting. For example, "prior to IFTA a single route from Denver to Los Angeles would require the carrier to file tax forms in five different states or to obtain permits from those five states." *Id.* 592.

The complexity of the system induced a few states to coordinate their fuel tax collection. In 1983, three states initiated ITFA. Shortly thereafter, a National Governors Association working group, funded by Congress, proposed a "Model Base State Fuel Use Tax Reporting Agreement," which incorporated the earlier ITFA concepts. By 1990, sixteen states had joined ITFA. A year later, Congress took a critical step – essentially making the states an "offer they could not refuse" – by requiring that "after September 20, 1996, no State shall establish, maintain, or enforce any law or regulation which has its fuel use tax reporting requirements ... which are not in conformity with the International Fuel Tax Agreement." Intermodal Surface Transportation Efficiency Act, Pub. L. No. 102-240, § 4008(g), 105 Stat. 2154 (Dec. 18, 1991), codified at 49 U.S.C. § 31705 (2006). States were further told that they "could not ... enforce any law or regulation which provides for the payment of a fuel use tax unless such law or regulation is in conformity with the International Fuel Tax Agreement." *Id.* On the other hand, states that conformed to IFTA were effectively empowered to administer and enforce motor fuel taxes through a regime that would have been virtually impossible to replicate without congressional authorization.

To make a long story short, today the 48 contiguous states and 10 Canadian provinces are signatories of IFTA. See www.itfach.org. Under IFTA, carriers designate a base reporting state to which they report all their fuel tax liabilities both in the base state and in any other state in which they operate. The carrier files its quarterly fuel use tax reports to the base state, reporting its operations in all member states. Depending on whether the carrier overpaid or underpaid its taxes at the pump, determined by the difference between the taxes paid at the pump and the taxes owed based on where its operations occurred, the carrier pays its base state the net taxes due or receives a credit for the net taxes overpaid. See Pitcher, Robert C., "The International Fuel Tax Agreement: Are There Lessons Here for Sales and Use Tax Taxation?," 25 *State Tax Notes* 11 (2001), pp. 887-91. The base state distributes to the other states what the carrier owes them, or accepts on its behalf credits from the other member states. *Id.* The carrier's base state audits the carrier on behalf of all the other IFTA members. *Id.*

In short, like the MTSA, IFTA reflects the judicious exercise of Congress's power to both expand and restrain state tax power in a manner that allows taxes to be collected in a sensible and uniform manner and at the same time protects taxpayers from burdensome taxation based on inconsistent rules in different states. It thus another example of a win-win solution for both states and taxpayers that would not have been possible without congressional intervention.

2. *What Works Poorly: The Internet Tax Freedom Act*

The Internet Tax Freedom Act (ITFA)[77] enacted by Congress in 1998 is a poster child for horizontal federal-state tax coordination at its worst. ITFA is normatively flawed, logically incoherent, and technically complex if not incomprehensible. Although I can touch only briefly on each these problems here, it should suffice to support the conclusion, and I have provided more detailed proof elsewhere.[78]

ITFA imposed a three-year moratorium (subsequently extended through 2014[79]) on three types of taxes: (1) taxes on Internet access; (2) discriminatory taxes on electronic commerce; and (3) multiple taxes on electronic commerce.

a. Normative Concerns

While a normative case can surely be made for barring "discriminatory" or "multiple" taxes on electronic commerce, ITFA's definition of these terms (considered below[80]) sweeps so much more broadly than their common understanding that ITFA's bar on such taxes basically raises the question as to whether electronic commerce should be taxed at all. In this respect, it raises the same question as that raised by the blanket prohibition of taxes on Internet access. As Charles McLure and I concluded after a detailed normative analysis of ITFA,[81] the case for congressional intervention was mixed:

> The case for exempting Internet access by households is weak, no matter how Internet access is defined (narrowly, as embracing only connection to the Internet or more broadly to include telecommunications and/or digital content). Even an exemption for only basic Internet access is an extremely inefficient way to achieve the posited objectives. On the other hand, all business purchases of Internet access, telecommunications, and digital content should be tax-exempt.[82]

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[77] Pub. L. No. 105-277, tit. XI, 112 Stat. 2681 (1998). For a general consideration of ITFA, see Hellerstein, Walter, "Internet Tax Freedom Act Limits States' Power to Tax Internet Access and Electronic Commerce," 90 *Journal of Taxation* 1 (1999), pp. 5-10. ITFA is not to be confused with IFTA – the International Fuel Tax Agreement – discussed in the preceding footnote.

[78] See Hellerstein, *supra* note 77; McLure and Hellerstein, *supra* note 1.

[79] See *infra* notes 89-97 and accompanying text.

[80] See *infra* notes 83-85 and accompanying text.

[81] McLure and Hellerstein, *supra* note 1, at 725-30.

[82] *Id.* at 730.

b. Logical Concerns

Even if one were undisturbed by the normative concerns raised by ITFA, the legislation suffers from serious logical defects. For example, ITFA bars multiple taxation of electronic commerce and, for this purpose, defines a multiple tax as

> any tax that is imposed by one State...on the same or essentially the same electronic commerce that is also subject to another tax imposed by another State...(whether or not at the same rate or on the same basis), without a credit (for example, a resale exemption certificate) for taxes paid in other jurisdictions. [83]

Congress excluded from this definition sales or use taxes imposed concurrently by a state and its political subdivisions on the same electronic commerce and "a tax on persons engaged in electronic commerce which may also have been subject to a sales or use tax thereon."[84]

Although one can discern Congress's objective in enacting this provision (i.e., to prevent the same electronic commerce from being subject to tax by more than one state), the language that Congress chose to accomplish that goal is opaque at best. While preventing more than one state from taxing "the same electronic commerce" might leave some room for debate, the prevention of states from taxing "essentially the same electronic commerce" is almost an invitation for controversy. Indeed, it reads more like cocktail party conversation than a carefully thought out restraint on state taxing power.

Moreover, Congress apparently believed that two states can tax "the same" or "essentially the same" electronic commerce, even if the two levies are not imposed "on the same basis." Does this mean, for example, that Texas may not impose a sales or use tax on computer software transmitted via the Internet from a Washington State software producer, because "essentially the same electronic commerce" was subject to Washington's Business and Occupation Tax? Or is this the situation to which the "savings clause" was directed (i.e., "a tax on persons engaged in electronic commerce"), which is not regarded as a "multiple tax" even if the same electronic commerce is subject to sales or use tax? If it is, however, the savings clause may defeat Congress's objective, because many state sales taxes are legally imposed on the vendor for the privilege of engaging in selling activities [85] (including, one would think, activities in electronic commerce). Hence, one could argue that duplicative sales or use taxation of electronic commerce is permissible as long as the legal incidence of one state's sales tax falls on the seller.

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[83] Pub. L. No. 105-277, § 1104(6)(A) (1998).

[84] *Id.* § 1104(6)(B).

[85] See Hellerstein, Walter, Michael J. McIntyre, and Richard D. Pomp, "Commerce Clause Restraints on State Taxation After *Jefferson Lines*," 51 *Tax Law Review* 1 (1995), pp. 47-114, at 76.

c. Technical Concerns

Beyond the normative concerns and concerns with the internal logic of the legislation, ITFA is hideously complex and is permeated with technical flaws. Merely describing the prohibition on taxation of Internet access and the struggles of state courts and administrative tribunals with its meaning makes the point. ITFA was originally enacted in October 1998 as a three-year moratorium barring states from taxing charges for "a service that enables users to connect to the Internet to access content, information, or other services offered over the Internet."[86] However, a grandfather provision excluded from ITFA's scope a tax on Internet access that was "generally imposed and actually enforced prior to October 1, 1998,"[87] and it also excluded the term "telecommunications services" from the definition of Internet access.[88] In November 2001, Congress retroactively extended ITFA for two years through October 2003.[89]

In late 2004, Congress again retroactively extended the act, this time through November 2007.[90] The 2004 extension of the moratorium added language making it clear that all forms of Internet access were covered by the moratorium, including high-speed wireline (DSL) and wireless service (i.e., telecommunications services "purchased, used, or sold by a provider of Internet access to provide Internet access").[91] At the same time, the 2004 ITFA

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[86] Pub. L. No. 105-277, §§ 1101(a) (1998).

[87] *Id.*

[88] *Id.* § 1104(5).

[89] Internet Tax Nondiscrimination Act, Pub. L. No. 107-75, 115 Stat. 703 (2001).

[90] Pub. L. No 108-435, 118 Stat. 2615 (2004).

[91] *Id.* § 2(c). The effect of this amendment was apparently to reverse decisions in cases like *America Online, Inc. v. Pennsylvania*, 932 A.2d 332 (Pa. Commw. 2007), *aff'd*, 942 A.2d 236 (Pa. Commw. 2008) (en banc), which held that the pre-2004 version of ITFA did not bar a Pennsylvania tax on port modem management services that, among other things, converted information transmitted over the Internet from digital to analog format for transmission to customers, and *Concentric Network Corp. v. Pennsylvania*, 877 A.2d 542 (Pa. Commw. 2005), which held that the pre-2004 version of ITFA did not bar a Pennsylvania tax on an Internet service provider's purchase of data transport services used to provide Internet access. Indeed, it is not even clear that the decision in *Concentric* was properly decided under the pre-2004 version of ITFA. The Pennsylvania tax did not apply to data-transport services purchased by cable companies and telecommunications carriers. The court held that the distinction did not violate the prohibition against "establish[ing] a classification of Internet access service providers...for purposes of establishing a higher tax rate on such providers than the tax rate generally applied to providers of similar information services delivered through other means." Pub. L. No. 105-277, § 1104(2)(A)(iv) (1998). The court reasoned that the exclusion was permissible because "[i]t is only in their capacity as public utilities or broadcasters that the telecommunications carriers or cable operators are permitted an exclusion." *Concentric*, 877 A.2d at 549. As Joseph Bright has observed in commenting on this opinion, however, "[i]f the federal statutes prohibit discrimination, it does not seem to be a sufficient justification that the discrimination is created by a second state statute." Bright, Joseph, "Court's Refund Denial on Internet Data Lines May Err on Federal Statute," 37 *State Tax*

extension provided that the prohibition did not apply to any tax on a voice or similar service using Internet Protocol (voice over Internet Protocol, or VOIP), except to the extent that the services were incidental to the Internet access (e.g., voice-capable email or instant messaging).[92]

In 2007, Congress yet again extended the act for an additional seven years through November 1, 2014.[93] The 2007 ITFA amendments expanded the definition of "Internet access" to include "a home page, electronic mail, and instant messaging (including voice- and video-capable electronic mail and instant messaging), video clips, and personal electronic storage capacity,"[94] whether packaged with Internet access or provided independently.[95] The 2007

Notes 1 (2005), p. 28. In an en banc decision rejecting the taxpayer's exception to the panel decision, *Concentric Network Corp. v. Pennsylvania*, 897 A.2d 6 (Pa. Commw. 2006) (en banc), *aff'd per curiam*, 922 A.2d 883 (Pa. 2007), the court rejected the taxpayer's claim that the levy violated ITFA's bar against taxes on Internet access, on the ground that the Pennsylvania tax fell within the "grandfather" clause preserving any tax that "was generally imposed and actually enforced prior to October 1, 1998." The en banc court also reaffirmed the panel's decision that the tax did not violate the prohibition against establishing a higher tax rate on Internet service providers than the rate generally applied to providers of similar information services delivered through other means, because "the Tax Code does not classify information service providers, nor does it establish different tax rates on information services providers." *Concentric*, 897 A.2d at 15. The court further observed:

> Moreover, Taxpayer pays sales and use tax because it uses other companies' wirelines to provide its services. Taxpayer is not prohibited by the Tax Code from installing its own wirelines or from using some other technology to provide its services. If it chooses an alternate solution, it will not pay sales and use tax on purchases of telecommunications services. In short, the tax at issue here results not from a discriminatory tax on electronic commerce but from Taxpayer's business decisions.

Id. See also Priv. Ltr. Rul. 5715, Mo. Dep't of Revenue, June 16, 2009, available at www.checkpoint.thomsonreuters.com (otherwise applicable sales tax on provision of T1 transport lines and dial modem ports to Internet service providers for carrying Internet traffic is preempted by ITFA, as amended in 2007, because it includes telecommunications used by an Internet service provider to provide Internet services). Priv. Ltr. Rul. 5594, Mo. Dep't of Revenue, Apr. 20, 2009, available at www.checkpoint.thomsonreuters.com (otherwise applicable sales tax on lease of broadband capacity to Internet service provider is preempted by ITFA, as amended in 2007, because it includes telecommunications used by an Internet service provider to provide Internet services).

[92] Pub. L. No 108-435, § 6, 118 Stat. 2615 (2004).

[93] Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat. 1024 (2007).

[94] *Id.* § 4.

[95] The definition of "Internet access," as revised by the 2007 ITFA amendments, provides that "Internet access"

> (A) means a service that enables users to connect to the Internet to access content, information, or other services offered over the Internet;
>
> (B) includes the purchase, use or sale of telecommunications by a provider of a service described in subparagraph (A) to the extent such telecommunications are purchased, used or sold—
>
> > (i) to provide such service; or
> >
> > (ii) to otherwise enable users to access content, information or other services offered over the Internet;
>
> (C) includes services that are incidental to the provision of the service described in subparagraph (A) when furnished to users as part of such service, such as a home page, electronic mail and instant messaging

amendments further excluded from the definition of "tax on Internet access" taxes that Michigan, Ohio, and Texas impose on gross receipts or gross income from business activity (in lieu of the typical state-level corporate income tax). The 2007 ITFA amendment also extended through 2014 the original act's grandfather clause covering preexisting state taxes on Internet that were "generally imposed and actually enforced prior to October 1, 1998."[96] In addition, however, the 2007 ITFA amendment adopted a more limited grandfathering provision for states that were taxing the telecommunications services that were covered by the moratorium for the first time (i.e., telecommunications services purchased, used, or sold to provide Internet access), which were grandfathered only through June 30, 2008.[97]

In short, ITFA is exactly what legislation designed to effectuate horizontal federal-state coördination should not be – normatively problematic, logically questionable, and a technical nightmare.

3. *What Works Passably but Defectively: Public Law 86-272*

Most existing federal legislation designed to effectuate horizontal federal-state tax coordination probably falls within the "passable but defective" category, namely, legislation that generally achieves its typically narrow objective, but with some collateral damage along the way. Public Law 86-272,[98] to which I have already alluded,[99] illustrates the point. As noted above (albeit without identifying the statute by its popular appellation), Public Law 86-272 was enacted in 1959 in direct and immediate response to the U.S. Supreme Court's decision *Northwestern States Portland Cement Co. v. Minnesota*,[100] which sustained the states' power to impose a fairly apportioned, nondiscriminatory tax on net income derived from interstate commerce. The statute prevents the states from taxing net income derived from interstate

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(including voice- and video-capable electronic mail and instant messaging), video clips, and personal electronic storage capacity;

(D) does not include voice, audio or video programming, or other products and services (except services described in subparagraph (A), (B), (C), or (E)) that utilize Internet protocol or any successor protocol and for which there is a charge, regardless of whether such charge is separately stated or aggregated with the charge for services described in subparagraph (A), (B), (C), or (E); and

(E) includes a homepage, electronic mail and instant messaging (including voice- and video-capable electronic mail and instant messaging), video clips, and personal electronic storage capacity, that are provided independently or not packaged with Internet access.

Id.

[96] See *supra* note 87 and accompanying text.

[97] Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, § 3,121 Stat. 1024 (2007).

[98] Pub. L. No. 86-272, 73 Stat. 555 (1959), codified at 15 U.S.C. §§ 381-84 (2006).

[99] See *supra* notes 59-60 and accompanying text.

[100] 358 U.S. 450 (1959).

commerce when the taxpayer's activities in the state are limited to the "solicitation" of orders for sales of tangible personal property that are fulfilled by shipments from outside the state.[101]

Somewhat ironically, Public Law 86-272's prohibition was designed merely as a temporary measure – a cease fire in place, as it were – while Congress considered broad-based legislation for horizontal tax coordination. Title II of Public Law 86-272 assigned to the House Judiciary Committee and the Senate Finance Committee the task of making "full and complete studies of all matters pertaining to the taxation by the States of income derived within the States from the conduct of business activities which are exclusively in furtherance of interstate commerce or which are a part of interstate commerce, for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the States in imposing income taxes on income so derived."[102] Despite a committee's production of an extensive and invaluable four-volume study (the Willis Committee Report) that recommended broad-based legislation providing for horizontal tax coordination,[103] Congress's failure to act on these recommendations is, as they say, history.

What we have instead is the legacy of more than half a century of efforts to determine the metes and bounds of a stopgap "minimum nexus" measure designed to protect the national common market without unduly restraining the states' power to tax.[104] Without prolonging this discussion any further, and indeed, providing an appropriate segue into the next part of this testimony,[105] it suffices to say that Public Law 86-272, while providing the core of tax immunity that Congress intended, at the same time has given rise to (a) considerable controversy over the scope of such immunity,[106] attributable in part, perhaps, to the narrow focus of the legislation and haste with which it was enacted; (b) an immunity based on a mid-twentieth century view of economic activity that may no longer reflect contemporary economic reality; (c) different jurisdictional standards depending on whether a taxpayer's income derives from the sale of tangible personal property, on the one hand, or from services or intangibles, on the other; and (d) extensive state tax planning to take advantage of the federal protection.

[101] 15 U.S.C. §§ 381-84 (2006).

[102] Pub. L. No. 86-272, Tit. II, 73 Stat. 555 (1959),

[103] Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, *State Taxation of Interstate Commerce*, H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Rep. Nos. 565 and 982, 89th Cong., 1st Sess. (1965)

[104] This legacy is reflected in the extensive body of case law and state administrative guidance spawned by Public Law 86-272, all of which is treated in detail in Hellerstein, Hellerstein and Swain, *supra* note 1, at ¶¶ 6.16–6.28.

[105] One of the principal current proposals pending before Congress is a broadening of Public Law 86-272.

[106] See *id*.

IV. CURRENT PROPOSALS FOR FEDERAL-STATE TAX COORDINATION

In light of the checkered history of legislation addressed to federal-state tax coordination, perhaps the first thing to say about the current spate of legislative proposals aimed at federal-state tax coordination is that "hope springs eternal in the human breast."[107] Among the legislative proposals recently introduced in Congress include bills that would:

- authorize the states to require remote vendors to collect sales and use taxes on sales to in-state purchasers, regardless of their physical-presence in the state (otherwise constitutionally required under *Quill*[108]) under specified conditions generally requiring harmonization and simplification of their sales and use tax regimes;[109]
- extend the protection of Public Law 86-272[110] beyond income from interstate commerce derived from the sale of tangible personal property to such income derived from all forms of economic activity and making other adjustments in the statute;[111]
- limit and define the circumstances under which states may impose income taxes on nonresidents temporarily employed in the state;[112]
- prohibit states from imposing "multiple or discriminatory" taxes on the sale or use of digital goods and services;[113]
- prohibit states from imposing a "discriminatory tax" on any means of providing multichannel programming;[114]
- impose a five-year moratorium on the imposition of by states or localities of any "new discriminatory tax" on mobile services, mobile service providers, or mobile service property;[115]

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[107] Alexander Pope, An *Essay on Man, Epistle I* (1733).

[108] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); see generally Hellerstein, Hellerstein, and Swain, *supra* note 1, at ¶ 19.02[3].

[109] See, e.g., S. 1452, 112th Cong., 1st Sess (2011) ("Main Street Fairness Act"); H.R. 2701, 112th Cong., 1st Sess. (2011) (same); S. 1832, 112th Cong., 1st Sess (2011) ("Marketplace Fairness Act"); H.R. 3179, 112th Cong., 1st Sess. (2011) ("Marketplace Equity Act of 2011").

[110] See *supra* notes 98-106 and accompanying text.

[111] H.R. 1439, 112th Cong., 1st Sess. (2011) ("Business Activity Tax Simplification Act of 2011").

[112] H.R. 1864, 112th Cong., 2nd Sess. (2012) ("Mobile Workforce State Income Tax Simplification Act of 2011").

[113] S. 971, 112th Cong., 1st Sess. (2011) ("Digital Goods and Services Tax Fairness Act of 2011"); H.R. 1860, 112th Cong., 1st Sess. 1860 (2011) (same).

[114] H.R. 1804, 112th Cong., 1st Sess. (2011) ("State Video Tax Fairness Act of 2011").

- prohibit a state from imposing a discriminatory tax on the rental of motor vehicles, the business of renting motor vehicles, or motor vehicle rental property;[116]
- prohibit a state from imposing a new unfair or inequitable E911 fee, tax, or surcharge with respect to prepaid mobile services, prepaid mobile service providers, or prepaid mobile customers;[117]
- prohibit a state from imposing a tax on a nonresident individual with respect to any time the individual is present in another state;[118] and
- make permanent the moratorium on Internet access taxes and the prohibition on multiple and discriminatory taxes on electronic commerce.[119]

It is plainly beyond the scope of the present endeavor to undertake a detailed analysis of any of these proposals, let alone all of them. Instead the more modest goal of this part of my testimony is briefly to examine these proposals in light of whatever lessons one might draw from the historical overview of federal-state tax coordination set forth in the preceding discussion.

A. The Main Street Fairness, Marketplace Fairness, and Marketplace Equity Acts

The Main Street Fairness Act,[120] the Marketplace Fairness Act,[121] and the Marketplace Equity Act of 2011[122] are all designed to authorize the states, under specified conditions generally requiring harmonization and simplification of their sales and use tax regimes, to require collection of sales and use taxes with respect to sales by remote sellers, notwithstanding their lack of physical presence in the state (otherwise constitutionally required by *Quill*[123]). Although the bills differ in their detail, such as the extent to which states must

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[115] S. 543, 112th Cong., 1st Sess. (2011) ("Wireless Tax Fairness Act of 2011"); H.R. 1002, 112th Cong., 1st Sess. (2011) (same).

[116] H.R. 2469, 112th Cong., 1st Sess. (2011) ("End Discriminatory State Taxes for Automobile Renters Act of 2011").

[117] H.R. 3788, 112th Cong., 2d Sess. (2012) ("E911 Surcharge Fairness Act of 2011").

[118] S. 1811, 112th Cong., 1st Sess. (2011) ("Telecommuter Tax Fairness Act of 2011").

[119] S. 135, 112th Cong., 1st Sess. (2011) ("Permanent Internet Tax Freedom Act of 2011").

[120] S. 1452, 112th Cong., 1st Sess (2011); H.R. 2701, 112th Cong., 1st Sess. (2011).

[121] S. 1832, 112th Cong., 1st Sess (2011).

[122] H.R. 3179, 112th Cong., 1st Sess. (2011).

[123] See *supra* note 108.

conform to the provisions of the Streamlined Sales and Use Tax Agreement ("SSUTA"),[124] the level of the exemption of "small" sellers from the tax collection requirement, and the precise extent of required harmonization, they share in common the concept of a "deal" authorizing collection of taxation from remote sellers in return for removal of existing burdens on such sellers through simplification and harmonization.

After undertaking a detailed analysis of an earlier (but essentially similar) version of the most demanding of these bills – the Main Street Fairness Act that applies only to states that have conformed to SSUTA – and evaluating it in light of the normative principles that ought to govern congressional intervention in state tax matters,[125] Charles McLure and I concluded that legislation along the lines outlined above was "fundamentally a move in the right direction – the prescription of simplification and greater uniformity in conjunction with the removal of nexus rules that create undesirable economic consequences."[126] We observed, among other things, that "under the prescribed conditions of simplification and uniformity, nexus rules would no longer be needed to reduce complexity and thus could no longer be justified."[127] In reaching our conclusion, we also identified the requirements of (1) reasonable vendor compensation and (2) the existence of "identical" state and local tax bases within any state as essential elements of the proposal we were endorsing. Finally, we noted that the proposed legislation struck "the proper balance between the interests of state sovereignty and those of national economic unity."[128] It respected the states' ability to establish their own tax rates, and, indeed, even went so far (perhaps further than we would have gone) as to allow the states freedom to define their own tax bases, although states were required to employ uniform definitions in determining what was and what was not taxable. At the same time, the proposed legislation imposed significant requirements on the states to harmonize and simplify their

[124] SSUTA (as amended through December 19, 2011) is reproduced at www.streamlinedsaletax.org. SSUTA is a voluntary agreement among the states designed to "simplify and modernize sales and use tax administration in order to substantiall reduce the burden of tax compliance." SSUTA § 102. See generally Hellerstein, Hellerstein, and Swain, *supra* note 1, ch. 19A for a detailed consideration of SSUTA. As of early 2012, there were 20 "full member" states under SSUTA with most of the other states with sales taxes either "associate members" (in principle moving to "full member" status) or "advisory member" (nonconforming) states. See www.streamlinedsalestax.org.

[125] McLure and Hellerstein, *supra* note 1.

[126] *Id.* at 731.

[127] *Id.*

[128] *Id.*

systems and thereby to provide the proper foundation for requiring collection by remote sellers without subjecting them to unreasonable administrative burdens.[129]

Although I cannot speak for McLure, it is less clear to me that the other versions of the sales and use tax collection authorization legislation, at least insofar as they would authorize collection by remote vendors by states not conforming to SSUTA, would satisfy the normative criteria we identified in our earlier article. To be sure, the alternatives to the SSUTA-conformity bills do require, with respect to remote sellers, identical state and local tax bases, a single sales and use tax return, a single state-level administrative agency, the provision of adequate software to ease compliance burdens, and "hold harmless" provisions that comply with such software.[130] On the other hand, there is no provision for compensation of remote sellers, nor is there any requirement that the states harmonize the definitions in their tax bases, a key feature of the SSUTA legislation.

Despite my reservations about the merits of some of the proposals for congressional legislation addressed to state sales and use tax collection and simplification, the legislation in principle constitutes the type of federal-state tax coordination that we should applaud and encourage. Like the "poster child" identified above for such legislation,[131] the proposed legislation combines the congressional relaxation of a judicially created rule restraining state tax power along with the imposition of congressionally imposed conditions. In both cases the judicially created rule is objectionable (although for different reasons) and in both cases the congressionally imposed conditions are desirable. Accordingly, in my judgment at least, legislation of this kind is template for future federal-state tax coordination.

B. The Business Activity Tax Simplification Tax Act of 2011

The Business Activity Tax Simplification Act of 2011[132] ("BAT Act") amends Public Law 86-272[133] to extend its protection beyond taxes on net income from interstate commerce

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[129] Notwithstanding our general agreement with the thrust of the SSUTA and the SSUTA-conformity legislation, we noted that there were many aspects of such legislation about which we were less than enthusiastic. Among other things, we expressed concern over the question whether SSUTA's simplification requirements would be "more than empty promises," *id.* at 732; we questioned whether the "small remote seller" thresholds established by SSUTA (which seem to change with every meeting of the Governing Board) made any sense, *id.* (they currently are a level of $5 million of "gross national remote sales," SSUTA § 609, with various qualifications); and we noted that our support of the legislation, despite some misgivings, was based in part our belief that we were" at a critical juncture where Congress has a unique opportunity to act" and that the SSUTA legislation may be "our 'last best chance' (at least during our lifetimes) of achieving significant, if less than perfect, reform and improvement of the state sales and use tax system." *Id.* The last statement is even truer today than the day we made it, as our life expectancies shrink.

[130] S. 1832, 112th Cong., 1st Sess. (2011); H.R. 3179, 112th Cong., 1st Sess. (2011).

[131] See *supra* notes 71-76 and accompanying text.

[132] H.R. 1439, 112th Cong., 1st Sess. (2011).

attributable to the sale of tangible personal property to such income attributable to any form of business activity (including the sale of services and intangibles) and to "business activity taxes" other than net income taxes, namely, gross receipts taxes. The proposed BAT Act also establishes a general nexus requirement of "physical presence" (employees, agents performing services, or property in the state), along with de minimis "safe harbor" exceptions (e.g., presence in the state for less than 15 days). Earlier in this testimony, I characterized the original version of Public Law 86-272 as legislation that "works passably but defectively"[134] In my view, the 2011 version is even worse and should be characterized as legislation that "works poorly."[135]

From a normative perspective, the BAT Act is deeply flawed. As in the case of the proposed sales tax collection/simplification legislation discussed above, Charles McLure and I undertook a detailed analysis of an earlier (but essentially similar) version of the BAT Act from a normative perspective,[136] and we concluded that it was "clearly inconsistent with the normative considerations" there identified.[137] Among other things, we observed that it would "expand the scope for the creation of 'nowhere income,'"[138] i.e., attribution of income to states where the taxpayer was not taxable, and thus aggravate the opportunities for tax planning and the revenue loss created by Public Law 86-272. We also addressed arguments in support of the legislation that we considered to be unsound, in particular, the suggestion by representatives of the business community that businesses that are not physically present in a state receive no benefits from the state and therefore should not be required to pay taxes to such state.[139] As we pointed out, this "line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to

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[133] See *supra* notes 98-106 and accompanying text.

[134] See *supra* Part III(B)(3).

[135] See *supra* Part III(B)(2).

[136] McLure and Hellerstein, *supra* note 1.

[137] *Id.* at 734.

[138] *Id.*

[139] *Id.* (citing e.g., Council on State Taxation, "Jurisdiction to Impose Business Activity Tax," a policy position, available at: http://www.statetax.org/Content/NavigationMenu/Legislative/Policy_Statements/Default271.htm The identical argument has been repeated throughout the debate over the BAT legislation most recently in hearings on current version of the BAT legislation. See *Hearing on H.R. 1439: Business Activity Tax Simplification Act of 2011*, Before the Subcomm. on Courts, Commercial and Administrative Law of the House Comm. on the Judiciary, 112th Cong., 1st Sess. (2011), p. 117 (reproducing Letter from Joseph R. Crosby, Council on State Taxation, April 13, 2011).

mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible."[140]

Moreover, it seems odd, to say the least, that Congress, under the guise of federal-state tax coordination, should be enshrining as a touchstone of taxability a standard first promulgated over half-century ago as a stop-gap measure[141] and one more appropriate for the economy of the nineteenth century than of the twenty-first. If certainty and administrability are the objectives – and these clearly *are* legitimate objectives that would justify congressional legislation prescribing state nexus rules – there are alternatives for certain and administrable nexus rules that make much more practical and economic sense than physical presence. Among these would be nexus rules based on sales or apportionment factors in the state.[142]

C. Mobile Workforce State Income Tax Simplification Act of 2011

The Mobile Workforce State Income Tax Simplification Act of 2011[143] prohibits the states from imposing income taxes (and requiring withholding of such taxes) on the wages or other remuneration earned by nonresident employees in the state unless they perform duties there for more than 30 days during the year. In my view, this is another example of what "works well" in federal-state tax coordination. To be sure, there is a clear intrusion into state sovereignty, because the states generally enjoy the power to tax the income that nonresidents earn within the state. [144] On the other hand, the burden on nonresidents from complying with tax reporting obligations arising out of temporary employment in the state and – perhaps even more importantly from the standpoint of our national economic market – the burden on employers of complying with withholding obligations with respect to such employees can be extremely onerous. Moreover, it is worth keeping in mind that we are talking largely about *which* state gets to tax the income in question, not whether the income gets taxed at all,

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[140] *Id.*

[141] See *supra* notes 100-102 and accompanying text.

[142] See McLure and Hellerstein, *supra* note 1, at 734; Avi-Yonah, Reuven, "International Taxation of Electronic Commerce," 52 *Tax Law Review* 3 (1997), 507-556, at pp. 531-41; Hellerstein, Walter, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective," 38 *Georgia Law Review* 1 (2003), pp. 1-70, at pp. 39-49; McLure, Charles E., Jr., "Implementing State Corporate Income Taxes in the Digital Age," 53 National Tax Journal 4, Part 3 (2000), pp. 1287-1305, at pp. 1295-97. Indeed, The Multistate Tax Commission approved a model "Factor Presence Nexus Standard for Business Activity Taxes" (available at www.mtc.gov).

[143] H.R. 1864, 112th Cong., 2nd Sess. (2012).

[144] Hellerstein, Hellerstein, and Swain, *supra* note 1, at ¶ 20.05[1].

because most states impose personal income taxes on all of the income earned by their residents, subject to a credit for taxes paid to other states.[145]

As I testified before a congressional committee considering an earlier (but similar) version of the legislation:

> In my opinion, enactment of the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007 would constitute an appropriate exercise of congressional power. In expressing this opinion, I wish to make it clear that I believe 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. The 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. Indeed, it is telling that a number of states themselves have implicitly recognized these burdens by adopting reciprocal provisions exempting income, or certain classes of income, earned by nonresidents in their state if the nonresident's home state grants a similar exemption to residents of the exemption-granting state.[146]

D. Prohibitions on "Discriminatory" Taxation of Specified Activities

A number of bills have been introduced into Congress to prohibit "discrimination" against specified activities. These include

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[145] *Id.* at ¶¶ 20.04[2], 20.10.

[146] *Hearing on H.R. 3359: Mobile Workforce State Income Tax Fairness and Simplification Act of 2007*, Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary, 110th Cong., 1st Sess. (2007), p. 82 (testimony of Walter Hellerstein). The following states have entered into reciprocal agreements exempting compensation paid in their states to residents of other states:

STATE	AGREEMENT WITH
District of Columbia	MD, VA
Illinois	IA, KY, MI, WI
Indiana	KY, MI, OH, PA, WI
Iowa	IL
Kentucky	IL, IN, MI, OH, VA, WV, WI
Maryland	DC, PA, VA, WV
Michigan	IL, IN, KY, MN, OH, WI
Minnesota	MI, ND
Montana	ND
New Jersey	PA
North Dakota	MN, MT
Ohio	IN, KY, MI, PA, WV
Pennsylvania	IN, MD, NJ, OH, VA, WV
Virginia	DC, KY, MD, PA, WV
West Virginia	KY, MD, OH, PA, VA
Wisconsin	IL, IN, KY, MI

See RIA State and Local Taxes for individual states, available at www.checkpoint.thomsonsonreuters.com (¶¶ 55,205, 55,325, and 55,875 for individual states).

- the Digital Goods and Services Tax Fairness Act of 2011 to prevent states from imposing "multiple or discriminatory" taxes on the sale or use of digital goods and services;[147]
- the State Video Tax Fairness Act of 2011 to prohibit states from imposing a "discriminatory tax" on any means of providing multichannel programming;[148]
- the Wireless Tax Fairness Act of 2011 to provide a five-year moratorium on the imposition by states or localities of any "new discriminatory tax" on mobile services, mobile service providers, or mobile service property;[149]
- the End Discriminatory State Taxes for Automobile Renters Act of 2011 to prohibit states from imposing discriminatory taxes on the rental of motor vehicles, the business of renting motor vehicles, or motor vehicle rental property;[150] and
- the E911 Surcharge Fairness Act of 2011 to prohibit states from imposing new unfair or inequitable E911 fees, taxes, or surcharges with respect to prepaid mobile services, prepaid mobile service providers, or prepaid mobile customers.[151]

These proposals resemble the targeted proposals typical of the limited federal-state tax coordination we have witnessed over the years including legislation forbidding states from taxing railroad, motor carrier, and air carrier property more heavily than other commercial and industrial property;[152] legislation forbidding the states from imposing electrical energy taxes discriminating against out-of-state purchasers;[153] and legislation imposing "discriminatory" taxes on electronic commerce.[154] As the preceding discussion suggests, in my judgment these narrow legislative initiatives have a mixed track record as to whether they work well, work poorly, or work passably but defectively. Because the category into which each of the proposals

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[147] H.R. 1860, 112th Cong., 1st Sess. 1860 (2011).

[148] H.R. 1804, 112th Cong., 1st Sess. (2011).

[149] S. 543, 112th Cong., 1st Sess. (2011); H.R. 1002, 112th Cong., 1st Sess. (2011) (same).

[150] H.R. 2469, 112th Cong., 1st Sess. (2011).

[151] H.R. 3788, 112th Cong., 2nd Sess. (2012).

[152] 49 U.S.C. §§ 11501, § 14502, 40116 (2006).

[153] 15 U.S.C. § 391 (2006).

[154] Internet Tax Freedom Act, Pub. L. No. 105–277, Div. C, Title XI, § 1104(3), 112 Stat. 2681 (1998) (as amended).

described above falls obviously depends on one's perspective. I would only suggest, at a minimum, that anyone who takes the time to read the efforts to define "discrimination"and related terms in these bills would have a hard time concluding that they would rank above "works passably but defectively." Indeed, the language of some of the proposals is so badly crafted that, at least in their present form, it is hard to imagine how they would not work "poorly." Perhaps one can hope for that happy day when every industry and every form of economic activity is protected by a federal statute prohibiting "discriminatory" taxation, a term that will be defined to require a uniform tax on household purchases (thus requiring a "sale for resale" exemption for all business purchases), so we would actually end up with an ideal retail sales tax in the United States.[155]

E. The Telecommuter Tax Fairness Act of 2011

The Telecommuter Tax Fairness Act of 2011 would prohibit states from imposing a tax on a nonresident individual with respect to any time the individual is present in another state.[156] This legislation is designed essentially to bar New York's "convenience of the employer" doctrine for determining the taxability of nonresidents' income associated with New York-based employment. Although I agree with this legislation as a matter of principle,[157] the case for congressional intervention into the controversy over New York's taxation of nonresidents pales by comparison to the significant issues that ought to be on Congress's federal-state tax coordination agenda.

V. CONCLUSION

If there is any overarching conclusion that one can draw from this overview of federal-state tax coordination, it may simply be that Congress should keep in mind the admonition of the Hippocratic Oath[158] – "first, do no harm" – in considering proposals for federal legislation that affect state taxation. Although Congress possesses power to provide for federal-state tax coordination that unquestionably advances the interests of all stakeholders, and it has sometimes exercised its power to achieve that end, it has also exercised its power in ways that unquestionably fail to meet that standard. Accordingly, in returning to the point with which this

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[155] See Hellerstein, Walter, Kirk J. Stark, John A. Swain, and Joan M. Youngman, *State and Local Taxation: Cases and Materials*, 9th ed. (St. Paul: Thomson Reuters, 2009), p. 611.

[156] S. 1811, 112th Cong., 1st Sess. (2011). ("Telecommuter Tax Fairness Act of 2011"). This legislation is designed essentially to bar New York's "convenience of the employer" doctrine for determining the taxability of nonresidents' income associated with New York-based employment. See generally Hellerstein, Hellerstein, and Swain, *supra* note 1, at ¶ 20.05[4][e].

[157] Hellerstein, Walter, "Reconsidering the Constitutionality of the 'Convenience of the Employer' Doctrine," 28 *State Tax Notes* 6 (2003), pp. 535-543.

[158] At least as popularly understood, whether historically accurate or not. See Wikipedia, http://en.wikipedia.org/wiki/Primum_non_nocere.

testimony began – Justice Holmes's observation that "a page of history is worth a volume of logic"[159] – perhaps we should aspire to add a few more pages of "logic" to the "volume" of our history in this domain.

[159] *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

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

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Hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
Before the Committee on Finance,
U.S. Senate

April 25, 2012

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]

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[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. Hewit*, 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., Willson 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.

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[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).

Nexus Based on Physical Presence

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 <u>millions of dollars</u> in business with the state but pay <u>zero tax</u> because they lack physical nexus."[17] At the same time, they write, "[m]any Washington-based businesses will see <u>reduced taxes</u>" (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

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[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*

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[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.

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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.

What Federal Tax Reform Means for State and Local Tax and Fiscal Policies

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Testimony before the Senate Committee on Finance, United States Senate
April 25, 2012

Chairman Baucus, Ranking Member Hatch, and Members of the Senate Finance Committee, thank you for inviting me to appear today to discuss federal tax reform and what it means for the tax and fiscal policies of state and local governments.

With increasing concerns about the federal deficit, fairness, and the complexity and inefficiency of our tax system, the need for fundamental federal tax reform is critical. Often overlooked, however, is the fact that any such reforms will also affect the tax and fiscal policies of state and local governments. As you consider possible changes in federal policy and, I hope, move toward a tax system that more efficiently raises revenue to provide federal services, it is important to recognize how federal actions affect state and local governments, as well as how state and local government actions can interact with and sometimes undo federal policy.

This hearing will touch on many subjects that affect state and local governments: broad fiscal policy, tax coordination and competition, tax-exempt bond markets, and fundamental income tax reform. I will focus my remarks on the current structure of state and local tax systems and how uncertainty about federal tax policy affects state and local governments' ability to forecast their own revenues. I will then examine how the federal tax code affects state and local budgets and how fundamental changes in the federal tax code may affect state and local governments. Our current system could definitely benefit from improvement: it is important to take into account how any changes shape not only federal revenues and economic activity but

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* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its trustees, or its funders. I have drawn on discussions and papers prepared for the "Federal Tax Reform Beyond the Beltway" conference on February 3, 2012, co-hosted by the Tax Policy Center and UCLA Law School and sponsored by the MacArthur Foundation, especially work co-authored with Kirk Stark of UCLA. Fiona Blackshaw, Leonard Burman, Tracy Gordon, Donald Marron, Kirk Stark and Roberton Williams provided helpful comments, but all errors are my own.

also the ability of state and local governments to access funds as well as the fiscal choices state and local governments make.

Although the country's economic condition is improving, state and local governments are still struggling to balance their budgets. Thus, decisions about changing federal policy should take into account the potential effects on state and local government budgets in both the short and the long run.

I will make seven points today about the relationship between federal tax reform and state and local fiscal policies.

1. *Although state revenues are recovering, state and local governments are still under enormous financial stress in the aftermath of the Great Recession.* Although the federal budget is roughly twice as large as states',[1] many federal programs are actually managed by the states. For example, state and county governments administer most Medicaid spending. Similarly, state and local governments are chiefly responsible for the development of transportation infrastructure. Aided by transfers from the federal government, state and local governments run about half of all public programs. They are predominant funders of K-12 education. But effective administration of those programs depends on states having stable revenue sources to finance their share of costs.

2. *Although federal grants and stimulus have helped states weather the downturn, other federal policies have exacerbated states' problems.*[2] Federal policy affects how attractive certain taxes are for state and local governments and, therefore, how those governments organize their tax and revenue systems. State revenue sources—especially income taxes—often piggyback on federal rules. More specifically, statutory changes in federal law can result in significant increases or decreases in state revenue. For example, state income tax revenue increased after the 1986 tax reform expanded the federal income tax base. On the other hand, state revenues have become

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[1] According to the National Income and Product Accounts, state and local government current receipts exceeded $2 trillion in 2010, including $500 billion in federal grants in aid. While federal revenues totaled $2.4 trillion, federal expenditures were $3.7 trillion (including grants in aid to state and local governments). When federal defense spending is excluded, state and local government spending is roughly equivalent to federal spending (15 percent vs. 18 percent of GDP) (BEA 2011).

[2] Gordon (2012) examines what lessons the federal government can learn from states and examines the federal/state relationship in the aftermath of the Great Recession.

more volatile over time as states have become more reliant on income taxes.[3] This is partly a result of the deductibility of state and local taxes on federal income tax returns. Deductibility effectively subsidizes state and local governments by offsetting the cost to taxpayers. By its very design, the deduction for state and local taxes favors certain fiscal choices over others. For example, only taxpayers who itemize their returns can benefit from the deduction. Because high-income taxpayers are more likely to itemize their deductions, state and local governments have an incentive to make their tax systems more progressive as a means of shifting more of the state's tax burden onto federal taxpayers.[4] This effect is intensified by the fact that deductions are most valuable to taxpayers with the highest marginal tax rate – the federal deduction is worth more to a taxpayer subject to a 35 percent tax rate than a taxpayer subject to a 15 percent tax rate. Again the clear incentive introduced by federal law is for states to concentrate their tax burdens on high-income households. This is not inherently bad; however, progressive income taxes tend to be more volatile than alternative revenue sources, thereby creating problems for governments that operate under balanced budget rules. In particular, they have less flexibility to respond to changing economic conditions.

3. *Unstable federal tax policy trickles down to the states.* Problems with state tax systems are exacerbated by uncertainty in federal tax rules. Temporary extensions of credits, deductions, and tax rates complicate state forecasting, particularly for state tax systems that piggyback on the federal code. Policy changes and uncertainty can lead taxpayer to change their behavior in ways that can indirectly affect state and local revenues and make projecting state revenues more difficult. For example, the California Legislative Analyst's Office 2012-2013 Budget: Economic and Revenue Outlook says that "Perhaps the most significant economic risks for this forecast relate to the unknown future direction of federal fiscal and tax policy." Especially problematic has been uncertainty about future federal estate taxes and tax rates on dividends and capital gains.

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[3] Increasing income inequality and income volatility have made state income tax receipts more volatile—up in good times, sharply down in bad (Pew Center 2011).

[4] Metcalf (2011) finds that federal deductibility continues to have a significant and large effect on the use of deductible taxes at the state and local level.

4. *The federal tax code makes the value of deductions and credits uncertain.* Because of phaseouts of tax preferences as well as the alternative minimum tax (AMT), taxpayers often cannot predict whether they will benefit from particular tax breaks. For example, the deduction for state and local taxes reduces the net cost of these taxes for taxpayers who can claim a deduction for them. The AMT disallows the deduction, however, and taxpayers often don't know whether they will be subject to the AMT before they fill out their tax returns. That uncertainty has been greater in recent years as Congress has temporarily increased the AMT exemption every year or two, sometimes only at the end of the tax year. Further, the probability of having to pay the AMT varies both across states (depending on the characteristics of their tax systems and other factors like house prices) and across types of households. Families in New York and California, for example, pay above-average state and local taxes and are also more likely to be subject to the AMT.[5]

5. *Reform of the federal tax system could benefit state and local governments if the effects on their tax systems are explicitly considered.* A streamlined federal income tax with fewer deductions and straightforward credits and deductions could allow for simpler state income tax returns. Many states already offer earned income credits and child care credits that piggy-back on the federal credits. Similarly, if federal tax reform includes the introduction of a value-added tax, state and local governments could replace their existing sales taxes with a consumption tax using the federal tax base whichwould likely be broader than the existing retail sales tax base including services plus web purchases. However, if federal reform is not done carefully, it could exacerbate existing problems and further complicate tax preparation, if states feel the need to introduce more provisions into their own codes to maintain their tax bases.

6. *The current state of the economy and still-fragile state and local budgets may require that transition relief to state and local governments accompany tax reform.* That could be especially true if the federal government moves quickly to change tax provisions that affect states and localities. For example, changing the deductibility of mortgage interest on second homes or moving from a deduction to a credit for mortgage interest could affect both house

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[5] Rueben and Stark (2012) examine differences across states in the prevalence and average size of the state and local tax deduction and the AMT; they also examine the distributional effects of varying the characteristics of the state and local tax deduction.

values and property-tax revenues. Changing the deductibility of state and local taxes and effectively eliminating the subsidy from the federal government could create pressure to cut state income tax rates just as revenues are recovering from the recession. Understanding the economic impact of such changes is critical. Providing relief through a transition period could lessen the impact on state and local revenues. Note, however, that temporary provisions and announced future changes can both affect taxpayer behavior.

7. *Congress can take specific actions to help coordinate and protect existing state and local tax systems.* State and local governments' ability to raise revenue can be hobbled by limitations that Congress could remove. Most notably, Congress could enact legislation that would enable state and local governments to collect taxes on internet and mail-order sales. Doing so could help stop the erosion of sales tax receipts as more and more commerce takes place online.

Thank you again for inviting me to appear today. I look forward to your questions.

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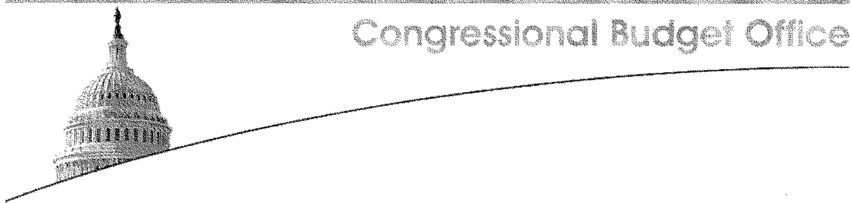

Testimony

Federal Support for State and Local Governments Through the Tax Code

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Before the
Committee on Finance
United State Senate

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Chairman Baucus, Senator Hatch, and members of the Committee, thank you for the invitation to testify on federal support for state and local governments provided through the tax code and on some ways in which tax reform might affect that support. My testimony focuses on two particular aspects of current policy: (1) the use of tax-preferred bonds by state and local governments for subsidizing investment in capital-intensive projects for such things as highways, water resources, and school buildings and (2) the deductibility of state and local taxes.[1]

The federal government provides preferential tax treatment for bonds issued to finance activities of state and local governments. As a result, those governments are able to borrow more cheaply than they otherwise could. At the end of 2011, state and local governments owed roughly $3 trillion in the form of tax-preferred bonds.

The most common type of tax-preferred bond is one for which interest income is exempt from federal taxes. Another type of tax preference for a state or local bond, which until recently has not been much used, is to offer a federal tax credit in lieu of some or all of the interest income from the bond.

Although a large majority of tax-preferred bonds are traditional tax-exempt bonds, such bonds are a relatively inefficient mechanism for the federal government to transfer funds to state and local governments. Specifically, with tax-exempt bonds, the federal government forgoes more in tax revenues than state and local governments receive. Estimates suggest that the difference is about $6 billion per year—or about one-fifth of the approximately $30 billion in federal revenues lost through that tax preference. That sum accrues to investors who pay high marginal tax rates. In contrast, for tax-credit bonds, the revenues forgone by the federal government are captured entirely by state and local governments.

However, tax-credit bonds have not been especially well received in financial markets until a few years ago. Investors' lack of enthusiasm for such bonds probably stemmed from the limited size and temporary nature of most tax-credit bond programs and an absence of rules for separating tax credits from the associated bonds and reselling them. In contrast, "direct-pay" tax-credit bonds—for which the value of the tax credit takes the form of a payment from the Treasury to the state or local government issuing the bond—became a significant source of state and local financing in the years during which they were authorized, namely, 2009 and 2010.

The deductibility of state and local taxes provides another means of federal support for state and local governments. Taxpayers who itemize their deductions may claim a deduction for most state and local taxes. That "taxes-paid" deduction provides an indirect federal subsidy to state and local governments because it decreases the net cost to taxpayers of paying such deductible taxes. By lowering the net cost of those state and local taxes, the taxes-paid deduction encourages state and local governments to impose higher taxes and provide more services than they otherwise would and to use deductible taxes in place of some nondeductible taxes. According to an estimate by the staff of the Joint Committee on Taxation, the tax subsidy provided through this deduction was $67 billion in 2011.[2]

How much a given state or local government benefits from this deduction depends on the structure of its tax system and the characteristics of the taxpayers who provide revenues to it. For example, a state or local government that finances its spending by using a larger share of taxes that are deductible under the federal individual income tax receives a larger benefit through the deductibility provision than does an otherwise identical government that finances its spending by using a smaller share of taxes that are deductible. All else being equal, a state or local government whose taxpayers are more likely to itemize deductions also gains a greater benefit than does a government whose taxpayers tend to claim the standard deduction.

In 2009, slightly fewer than one-third of all tax filers claimed the deduction for state and local taxes paid. The amount of those taxes paid generally increased with income, as did the tax saving from the deduction and the

1. For previous analysis of these topics, see Congressional Budget Office and Joint Committee on Taxation, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds* (October 2009); and Congressional Budget Office, *The Deductibility of State and Local Taxes* (February 2008).

2. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures, 2011–2015*, JCS-1-12 (January 17, 2012).

likelihood that a taxpayer would claim the deduction. For example, approximately 25 percent of tax filers with income under $100,000 claimed the deduction in 2009, compared with over 85 percent of tax filers with income of $100,000 or more.

Over the next several years, scheduled changes to tax provisions and the interaction of the regular income tax and the alternative minimum tax (AMT) will change the number of taxpayers who claim the deduction and the associated loss of federal revenues because the AMT does not allow people to claim the taxes-paid deduction. Without further changes to tax law, the number of taxpayers subject to the AMT will rise in 2012 because temporarily higher AMT exemption levels expired at the end of last year; as a result, fewer people will be able to claim the taxes-paid deduction. Also, without further changes to tax law, tax provisions originally enacted in 2001 and 2003 will expire at the end of 2012, increasing regular income tax rates for many taxpayers. Those increases will raise the value of the taxes-paid deduction for those who claim it and increase the associated revenue loss for the federal government. In addition, with the higher tax rates, many taxpayers will shift from being subject to the AMT (even if the current lower AMT exemption levels remain in place) to being subject to only the regular income tax and will therefore be able to claim the deduction for state and local taxes paid.

If certain tax policies that have recently been in effect were extended rather than being allowed to expire, as under current law, the revenue effects of the taxes-paid deduction would be different. Specifically, if all tax provisions expiring after 2012 (including the lower regular income tax rates originally enacted in 2001 and 2003) were extended and the AMT exemption levels were increased for years after 2011, there would be two opposing effects on the taxes-paid deduction. First, the lower regular income tax rates would reduce the tax saving and associated revenue loss for the federal government for taxpayers claiming the deduction. Second, the higher AMT exemption levels would reduce the number of taxpayers subject to the AMT, thereby increasing the number of taxpayers who would claim the deduction.

Federal Financial Support to State and Local Governments

The federal government provides financial support to state and local governments in a variety of ways. The largest amount comes to state and local governments in the form of grants, but the federal government also delivers support through the federal tax code by provisions that make it less expensive for state and local governments to raise revenues through their own tax collections and to borrow money by issuing bonds. That federal financial support covers the gamut of state and local government activities—including ones involving education, assistance to individuals and families with limited resources, transportation systems, and other infrastructure projects.

Magnitude of Federal Financial Support

Federal outlays for grants to state and local governments totaled $607 billion in 2011, or roughly one-quarter of all state and local government expenditures (which in 2011 amounted to $2.5 trillion).[3] Health care programs accounted for nearly half of those grants, including $275 billion for Medicaid. Most of the remaining grants went to fund programs in income security; education, training, employment, and social services; and transportation. Such grants are funded through both annual appropriations and the authorizing legislation of some mandatory programs.[4]

Another type of federal financial support is in the form of tax subsidies that make it less costly for state and local governments to raise revenues through taxes or to borrow. In 2011, according to estimates by the staff of the Joint Committee on Taxation, the federal tax subsidy deriving from the deduction for state and local taxes was $67 billion, and the tax subsidy for bonds issued by state and local governments totaled about $30 billion. The tax subsidy for state and local taxes is one of the largest "tax expenditures" in the individual income tax, exceeded only by the exclusion of pension contributions and earnings, the exclusion of employers' contributions for health care,

3. *Budget of the United States Government, Fiscal Year 2013: Analytical Perspectives*, Table 18.1; and Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, February 13, 2012, Table 3.3.

4. The federal government also offers loans and loan guarantees to state and local governments for a number of different purposes, including state unemployment programs, community development projects, and disaster aid.

the reduced tax rate for capital gains and dividends, and the deduction of mortgage interest.[5]

Tax Subsidies vs. Grants

The mechanisms by which the federal government gives financial support to state and local governments offer different degrees of federal control over the amount of the support, the uses of those federal funds, the distribution of that support across jurisdictions and individuals, and transparency in the federal budget process.

The amount of the federal tax subsidy for the state and local tax deduction and for tax-preferred state and local bonds depends on state and local governments' tax and spending policies and on the tax circumstances of the individuals who opt to take the deduction and the individuals and firms who purchase those government bonds. The amount of some federal grants to state and local governments is specified in the appropriating or authorizing legislation of the grant program. For other programs, including Medicaid, the authorizing legislation sets out how the spending is to be divided between the federal government and state and local governments but also gives those governments considerable decisionmaking power that helps to determine the amount of federal spending.

Control over the use of federal funds varies widely depending on the financing mechanism. For subsidies provided through the federal tax system, the federal government has no control over how state and local governments spend the funds as long as the subsidized tax revenues and bonds are used for a governmental purpose. For grants, the federal government may specify the purpose for which the funds are to be spent, impose other conditions on that spending, and require state and local governments to spend out of their own resources. However, the fungibility of those federal grant funds raises the possibility that state and local governments may reallocate their other spending as a result of the federal grants they receive.

The distribution of the federal tax subsidies that support state and local governments depends on the mix of state and local policies at play and the incomes of residents. Although specific individuals and firms may have smaller federal tax liabilities as a result of those tax subsidies, the benefits of those subsidies may extend to all residents to whom federally subsidized state and local government goods and services are provided. Federal grants are typically allocated among state and local governments by formulas or other rules set out in legislation. The participants in those grant programs may be the most direct beneficiaries, but others in their communities may receive spillover benefits.

The federal tax subsidies that support state and local governments do not appear as spending in the federal budget, making the amounts of support less evident, though the staff of the Joint Committee on Taxation provides annual estimates of those and other tax expenditures separately. In contrast, grants to state and local governments are specified in appropriating or authorizing legislation as either a dollar amount or a formula with a set of criteria for spending the funds. They appear in the federal budget as either discretionary or mandatory spending as determined by the specifics of each grant program. For discretionary programs, lawmakers make decisions about appropriation amounts annually.

Tax-Preferred Bonds

The federal government offers preferential tax treatment for bonds issued by state and local governments to finance governmental activities. Most tax-preferred bonds are used to finance schools, transportation infrastructure, utilities, and other capital-intensive projects. Although there are several ways in which the tax preference may be structured, in all cases state and local governments face lower borrowing costs than they would otherwise.

Types of Tax-Preferred Bonds

Borrowing by state and local governments benefits from several types of federal tax preferences. The most commonly used tax preference is the exclusion from federal income tax of interest paid on bonds issued to finance the activities of state and local governments. Such tax-exempt bonds—known as governmental bonds—enable state and

5. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures, 2011–2015*. Tax expenditures are defined under the Congressional Budget and Impoundment Control Act of 1974 as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Tax expenditure estimates, unlike revenue estimates, do not take into account any changes in taxpayers' behavior in response to changes in the tax code.

local governments to borrow more cheaply than they could otherwise.

Another type of tax-exempt bond—qualified private activity bonds, or QPABs—is also issued by state and local governments. In contrast to governmental bonds, QPABs reduce the costs to the private sector of financing some projects that provide public benefits. Although the issuance of QPABs can be advantageous to state and local finances—for example, by encouraging the private sector to undertake projects whose public benefits would otherwise either have gone unrealized or required government investment to bring about—states and localities are not responsible for the interest and principal payments on such bonds. Consequently, QPABs are not the focus of this testimony (although the findings of some studies cited later in this section apply to them as well as to governmental bonds).[6]

A final type of tax preference for state and local borrowing takes the form of a tax credit to buyers of bonds issued to finance governmental activities. Such bonds have not generally proved popular with investors, however, and recently have been reconfigured to allow the state and local governments issuing them to claim the tax credits in the form of direct payments from the Treasury. Particularly in 2009 and 2010, when the American Recovery and Reinvestment Act of 2009 (Public Law 111-5) authorized Build America Bonds, for which those direct payments to issuers occurred, tax-credit bonds became a significant source of federal financial support for state and local borrowing. Greater use of such direct-pay tax-credit bonds and tax-credit bonds more generally offers the prospect of both increased efficiency in providing a federal financial subsidy to state and local governments and greater transparency in how that subsidy is delivered.

Uses of Tax-Preferred Bonds

With the exception of some types of tax-preferred bonds, states and localities can use tax-preferred debt to finance just about any government activity.[7] According to the data in the Flow of Funds reports published by the Federal Reserve, at the end of 2011 there was approximately $3 trillion in outstanding liabilities of state and local governments, almost all of which (98 percent) was in the form of long-term debt.[8] More than half of that debt was issued by localities. According to the latest available data from the Bureau of the Census, long-term outstanding debt obligations of local governments totaled $1.6 trillion at the end of the second quarter of 2009, and the corresponding figure for states was $1 trillion.[9] Most of those long-term governmental bonds, as well as Build America Bonds during the several years in which they were authorized, were issued to finance capital spending (or investment).

State and local governments vary in their amount of outstanding debt and the interest payments associated with it depending on the purpose for which the debt has been issued—reflecting the different focus of each level of government. For example, states have a larger amount of outstanding debt and interest payments from investments in highway infrastructure than do localities; states' annual capital spending for that purpose is several times larger than localities'. For investment in utilities infrastructure (such as water and gas facilities), the situation is reversed. State and local governments sometimes also use short-term governmental bonds (with a maturity of less than 13 months) to finance government operations, particularly during periods when revenues fall below expenses. But such bonds (known as revenue anticipation notes, or RANs) account for only about 2 percent of the debt owed by those governments.

To finance new capital spending by state and local governments, $216.4 billion in governmental and Build America Bonds was issued in 2009 (see Table 1).[10] About 60 percent of those proceeds financed investment in education, transportation, and utilities. The shares for

6. According to an estimate by the Federal Reserve, at the end of 2011 the amount of outstanding qualified private activity bonds was approximately $752 billion. See Federal Reserve, Flow of Funds (statistical release, March 8, 2012), www.federalreserve.gov/releases/z1/. For a comprehensive discussion of QPABs and other tax-preferred bonds, see Congressional Budget Office and Joint Committee on Taxation, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds*.

7. However, issuing tax-preferred bonds to realize arbitrage gains (by investing bond proceeds to earn a higher, taxable rate of return) is prohibited.

8. See Federal Reserve, Flow of Funds (statistical release, March 8, 2012), www.federalreserve.gov/releases/z1/.

9. See Bureau of the Census, State and Local Government Finances by Level of Government and by State: 2008-09, www.census.gov/govs/estimate/.

10. That total omits $3.7 billion of other tax-credit bonds that were used primarily to finance school construction.

Table 1.

Governmental and Build America Bonds Issued, 2009

(Billions of dollars)

	Total		Bonds for New Capital Spending			
			Total		Amount, by Type	
Purpose of Bond	Amount	Percent	Amount	Percent	Governmental	Build America
Education	91.9	28	65.5	30	45.9	19.6
Transportation	50.1	15	38.4	18	20.1	18.3
Utilities	44.9	14	25.2	12	18.2	7.0
Environment	20.8	6	15.1	7	10.9	4.1
Public Safety	7.4	2	6.2	3	4.3	1.9
Health and Hospital	7.8	2	5.1	2	2.6	2.5
Housing	1.0	0	0.6	0	0.3	0.3
RANs and Other Bonds	2.0	1	1.7	1	1.6	0.1
Unspecified Purposes	101.9	31	58.7	27	47.1	11.6
Total	**327.8**	**100**	**216.4**	**100**	**151.1**	**65.3**

Source: Congressional Budget Office based on data from the Internal Revenue Service.

Notes: Governmental bonds have a maturity of at least 13 months.

Build America Bonds were authorized by the American Recovery and Reinvestment Act for issuance in 2009 and 2010. The Build America Bonds reported in this table were direct-pay tax-credit bonds.

The table omits $3.7 billion of other tax credit bonds that were used primarily to finance school construction.

Numbers may not add up totals because of rounding.

RAN = revenue anticipation note.

those various purposes are very similar to the average amounts since 1991.[11]

Build America Bonds accounted for 30 percent ($65.3 billion) of the total amount of such bonds issued in 2009. All of those Build America Bonds took the form of direct-pay tax-credit bonds. The amount almost doubled in 2010 (to about $115 billion). Their popularity stemmed from several factors. Because the interest rate subsidy of 35 percent that the federal government provided was considerably larger than the reduction in financing costs that state and local governments could obtain by issuing traditional tax-preferred bonds, those governments were eager to issue Build America Bonds. In addition, because the interest payment is fully taxable, pension funds and other investors with low or no income tax liability had an incentive to purchase them.

Impact of Tax-Preferred Bonds on State and Local Budgets

Federal tax exemptions for interest income from governmental bonds enable issuers of such debt to sell bonds that pay lower rates of interest than do taxable bonds with the same maturity, risk, and other characteristics. The lower the rate of interest that state and local governments must pay on their debt, the more funds they have available to provide government operations and the greater the amount of debt they can service and, therefore, the greater the amount of investment they can make.[12]

11. Note that over 30 percent of the proceeds from governmental bonds issued in 2009 were reported by their issuers as being for "other purposes," which means either that the specific purpose(s) listed on the reporting form did not apply or that the issuer did not allocate the bonds' proceeds among separate purposes. That share is also very close to its average from 1991 to 2009.

12. The interest rate subsidy from Build America Bonds and other tax-credit bonds has a similar impact on state and local budgets. Debt-service payments are made from current revenues and in many states are subject to requirements for a balanced budget, which constrain the funds available for government operations. In contrast, expenditures for capital investments—often from the proceeds from issuing tax-exempt bonds—are reported in a capital budget and are not subject to those requirements. For a detailed discussion of capital budgeting, see Congressional Budget Office, *Capital Budgeting* (May 2008).

The interest rate those governments pay is the rate that matches the supply of tax-exempt bonds with the demand for them, which is determined by the last buyer needed to equalize supply with demand and "clear" the market. That interest rate is therefore the yield that all issuers of comparable tax-exempt debt must pay. Because purchasers of tax-exempt bonds demand a return that is at least as high as the after-tax yield they could obtain from comparable taxable bonds, the amount by which the federal tax preference lowers the rate of interest on tax-exempt bonds—and thus the amount of savings in financing costs enjoyed by state and local governments—largely depends on the income tax rate of the market-clearing buyer of tax-exempt bonds.

Data on tax-exempt and taxable bond transactions allow a rough estimate of the marginal tax rate for the market-clearing buyer of tax-exempt bonds and, hence, the amount that states and localities save in financing costs by issuing such bonds. In 2009, the average yield on (taxable) high-grade corporate bonds was 5.3 percent, and the average yield on tax-exempt municipal bonds of similar creditworthiness was 4.6 percent—a difference of 0.7 percentage points, or approximately 13 percent of the taxable return. That 13 percent also represents the marginal tax rate at which an investor would be indifferent between purchasing a taxable bond yielding 5.3 percent and a tax-exempt bond yielding 4.6 percent.[13]

The implicit tax rate for market-clearing buyers of tax-exempt bonds from 2008 to 2010 ranged from 13 percent to 16 percent, considerably lower than the average of 21 percent during the prior two decades.[14] Investors' appetite for risk, the desired time horizon of their investments, and other features of the bonds can also influence the demand for taxable and tax-exempt debt. Turbulence in financial markets during the 2008–2010 period led investors to favor less risky debt—such as U.S. Treasury securities—over tax-exempt debt, thereby raising the (relative) yield on state and local bonds. For example, the yields on U.S. Treasury securities with 10- and 30-year maturities in 2009 were 3.3 percent and 4.1 percent, respectively, which are considerably lower than the contemporaneous yield of 4.6 percent on tax-exempt bonds—in spite of the fact that U.S. Treasury securities are subject to federal income tax.[15]

It is possible to use the implied savings in interest rate costs from a comparison of tax-exempt and taxable bond yields to roughly determine the impact of the tax exemption of governmental bonds on state and local budgets. For example, in 2007—the year immediately preceding the turmoil in financial markets and the exceptionally low implied reduction in financing costs through issuing tax-exempt bonds—state and local governments issued $200 billion in governmental bonds for new capital spending. The comparison of the yields on high-grade corporate bonds and tax-exempt bonds of comparable creditworthiness (5.6 percent and 4.4 percent, respectively) suggests that the tax exclusion for bond interest income shaved 1.2 percentage points off of the interest rate those governments would have paid if they had issued taxable debt. Thus, the tax exclusion provided states and localities a first-year interest subsidy of over $2 billion on the debt they issued in 2007 to fund their activities.[16]

13. The precision of the estimated tax rate depends heavily on the comparability of the tax-exempt and taxable bonds. In particular, depending upon how the "comparable" taxable bond is selected, different levels of cost savings can result. For example, if the tax-exempt bond is compared with a U.S. Treasury security, the estimated marginal income tax rate for the market-clearing bond buyer will be smaller than if it is compared with a corporate bond (as in the example in the text).

    Additionally, because the data on both tax-exempt and taxable interest rates used in this analysis are averages for bonds in each category that may still vary somewhat in terms of their risk, their time to maturity, the nature of their interest payments (fixed versus variable), and other features, the marginal tax rate implied for the market-clearing buyer of tax-exempt bonds may not be equal to the rate specified by the tax code. In 2009, for example, the marginal personal income tax rate for such buyers was either 10 percent or 15 percent.

14. See Joint Committee on Taxation, *Present Law and Issues Related to Infrastructure Finance*, JCX-83-08 (October 24, 2008), p. 28, www.house.gov/jct/x-83-08.pdf). The implied tax rates during that time ranged from 17 percent to 27 percent.

15. The bond yields cited in this testimony come from Council of Economic Advisers, *Economic Report of the President* (February 2012), Appendix B, Table B-73, p. 404, www.whitehouse.gov/administration/eop/cea/economic-report-of-the-President.

16. A similar calculation for 2009 suggests that the reduction in first-year financing costs for state and local governments amounted to roughly $1 billion. However, the tax exclusion for interest income from governmental bonds was not the only type of federal financing subsidy provided to those governments in that year. As described in more detail elsewhere in the testimony, issuers of Build America Bonds also received direct payments from the federal government that defrayed a substantial portion of the interest payable on that debt.

Increasing the Efficiency of Federal Tax Preferences for State and Local Borrowing

From the federal government's perspective, tax-exempt bonds are an inefficient means of providing a subsidy for debt financing. The amount of the tax preference provided is larger than the financing subsidy conveyed to state and local governments. As the issuers of tax-exempt debt expand the pool of bond purchasers until it is sufficiently large to exhaust the amount of debt they are offering, they draw in buyers from ever lower income tax brackets by raising the interest rate enough so that the yield on tax-exempt bonds is competitive with the after-tax rate of return on taxable investments available to those buyers. As a result, the market-clearing buyer of tax-exempt bonds will typically demand a tax-exempt yield that exceeds what an individual in a higher income tax bracket requires to purchase those bonds. Because there are multiple tax brackets and the market-clearing purchaser of municipal bonds will probably be in a lower bracket than many other bondholders, the loss of federal receipts is greater than the reduction in interest costs for the issuers of the tax-exempt bonds.

Several analysts suggest that about 80 percent of the tax expenditures from tax-exempt bonds translates into lower borrowing costs for states and localities, with the remaining 20 percent taking the form of a federal transfer to bondholders in higher tax brackets.[17] Consequently, a direct appropriation of funds to state and local governments would subsidize more spending per dollar of impact on the federal budget.

Tax expenditures for tax-exempt bonds are estimated as the product of forgone taxable income and the marginal income tax rate of the average holder of tax-exempt bonds—where forgone taxable income is estimated on the basis of the outstanding stock of tax-exempt debt and an estimate of the return that would be realized if those bond holdings were instead in the form of taxable investments (usually assumed to be taxable bonds of comparable risk and maturity). For 2011, according to estimates by the staff of the Joint Committee on Taxation, those tax expenditures by the federal government totaled $30.4 billion.[18] If 20 percent of the federal revenue loss from tax-exempt bonds accrued to bondholders in higher tax brackets without lowering borrowing costs, then the transfer to them was approximately $6 billion.

Using tax-exempt bonds to finance government activities is regressive, because the amount by which the benefits captured by investors in governmental bonds exceeds the issuers' cost savings increases with taxpayers' marginal tax rates. One study estimates that eliminating the tax exemption on state and local debt (including qualified private activity bonds) would reduce after-tax income primarily for taxpayers in the highest income quintile—and particularly for individuals in the top 1 percent of the income distribution.[19] Another study estimates that 53 percent of the outstanding stock of tax-exempt bonds in 2003 was held by households with marginal tax rates in excess of 30 percent, with the holdings of the remaining tax-exempt bonds distributed throughout most of the lower income tax brackets.[20]

Tax-Credit Bonds. Starting in the late 1990s, lawmakers turned to tax-credit bonds as a way to address the inefficiency of tax-exempt financing. Early forms of tax-credit bonds allowed bondholders to receive a credit against their federal income tax liability instead of the cash interest typically paid on the bonds. The amount of the tax credit equals the credit rate, which is set by the Secretary

17. See Dennis Zimmerman, *The Private Use of Tax-Exempt Bonds: Controlling Public Subsidy of Private Activity* (Washington, D.C.: Urban Institute Press, 1991), pp. 103–104; and James Poterba and Arturo Ramirez Verdugo, "Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds, *National Tax Journal*, vol. 64, no. 2 (June 2011), pp. 591–613. The latter authors estimate that in 2003, the marginal income tax rate for the average investor in tax-exempt bonds was 26.8 percent, and the tax rate for the market-clearing buyer of municipal bonds was between 13 percent and 22 percent. Their analysis is restricted to households and does not include corporations, which account for between one-quarter and one-third of the total tax expenditures from tax-exempt bonds estimated for the 2008–2012 period.

18. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures, 2011–2015.*

19. The decrease in after-tax income that results from eliminating the tax exemption is estimated to be at or near zero for all but the top income quintile; after-tax income falls by 0.24 percent for that quintile and 0.50 percent for the top 1 percent. See Leonard Burman, Eric Toder, and Christopher Geissler, "How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?" Discussion Paper No. 31 (Washington, D.C.: Urban Institute, December 2008), p. 11, www.urban.org/publications/1001234.html.

20. See James Poterba and Arturo Ramirez Verdugo, "Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds."

of the Treasury, multiplied by the face amount of the holder's bond. Because bondholders pay taxes on the amount of credit they claim, tax-credit bonds do not, in contrast to tax-exempt debt, provide a revenue transfer to investors in high marginal tax brackets. As a result, the tax preferences for tax-credit bonds reduce state and local borrowing costs dollar for dollar. Tax-credit bonds also allow the amount of federal subsidy to vary on the basis of the desirability, from the federal government's perspective, of the different types of projects being financed. Thus, tax-credit bonds offer the promise of increasing the efficiency with which federal resources are allocated to support infrastructure and other investments, as well as altering the distribution of those resources.

The early tax-credit bond programs were not particularly well received by financial markets for a number of reasons, including the limited size and temporary nature of the programs and the absence of rules for separating tax credits from the associated bonds and reselling them (which could have made such bonds advantageous to investors whose income tax liability did not allow them to immediately claim the full value of the credit).

Build America Bonds. The American Recovery and Reinvestment Act authorized Build America Bonds, a new type of tax-credit bond that was sold only in 2009 and 2010. State and local governments were authorized to issue Build America Bonds either as traditional tax-credit bonds or, if certain conditions were met, as direct-pay tax-credit bonds (known as qualified Build America Bonds). In contrast to earlier tax-credit bonds, Build America Bonds had an interest rate (or coupon) that was set by the issuers rather than by the Secretary of the Treasury. In the direct-pay scenario, a credit equal to 35 percent of each interest payment could be claimed by an issuer in lieu of a tax credit going to the bondholder. Because state and local governments issuing direct-pay Build America Bonds are not liable for taxes on that credit, they pay less interest than they would for Build America Bonds that provide the credits to bondholders. As a result, the direct-pay version of the bonds proved to be the one that issuers used, and the amount issued was substantial. Sales of those bonds totaled roughly $181 billion during the 2009–2010 period.

Direct-pay tax-credit bonds offer several advantages over other types of tax-preferred bonds. Making a payment directly to state and local governments to compensate them for the interest they pay on direct-pay tax-credit bonds is a more cost-effective way to provide a federal subsidy than offering a tax exemption on interest income. CBO has estimated that replacing the current tax exclusion on interest income from governmental bonds (and qualified private activity bonds) with direct-pay bonds at a 15 percent subsidy rate—roughly equal to the implicit subsidy rate discussed above for governmental bonds issued in 2009—would reduce budget deficits by $30.5 billion from 2012 to 2016 and by $142.7 billion from 2012 to 2021.[21]

Making subsidy payments to the issuers of bonds could improve federal budgeting practice. By paying state and local bond issuers a direct subsidy, the federal government would know the exact amount of financing subsidy it was providing in a given year. That information would allow for several types of evaluations. For example, policymakers could readily compare the cost of that subsidy with the cost of other types of assistance to state and local governments for similar purposes. In addition, policymakers could examine the distribution of the federal financing subsidy among states. The federal tax exemption redistributes funds to constituents in the states and localities that make especially heavy use of it, but the amounts by which individual states and localities benefit are not evident in the federal budget.

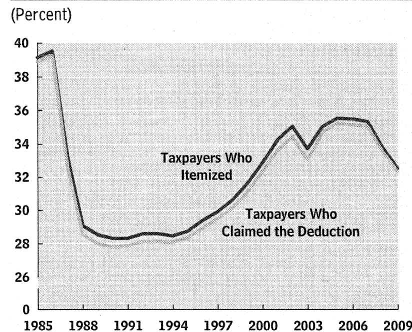
Making payments directly to bond issuers could also increase the federal government's control over the amount of its financial assistance. Under current practice, the federal government's control over the amount of the subsidy provided through the tax exemption is limited. The amount is not decided through the annual appropriation process—as is, for example, spending on infrastructure and other discretionary programs. Indeed, because the savings in interest costs enjoyed by state and local borrowers by issuing tax-exempt rather than taxable bonds depends largely upon the marginal income tax rate of the market-clearing bond buyer, the amount of subsidy delivered by that tax preference is mainly determined indirectly by the federal tax code (along with other factors that influence the demand for tax-exempt bonds).

21. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), p. 163–164.

Figure 1.

Percentage of Taxpayers Who Itemized and Who Claimed the Taxes-Paid Deduction, 1985 to 2009

(Percent)



Source: Congressional Budget Office based on data from the Internal Revenue Service.

Note: The taxes-paid deduction allows taxpayers to deduct from their adjusted gross income some of the taxes they pay to state and local governments, including income, real estate, personal property, and other taxes. From 2004 to 2009, taxpayers had the option to deduct general sales taxes in lieu of income taxes.

Deductibility of State and Local Taxes

Taxpayers who itemize deductions on their federal income tax returns may, with some limitations, deduct payments for certain state and local taxes from their reported income. In particular, under the rules for determining tax liability for 2011, taxpayers who itemized their deductions could deduct from their adjusted gross income (AGI) state and local real estate taxes, personal property taxes, and either income taxes or general sales taxes. About one-third of tax filers opted to itemize deductions on their federal income tax returns in 2009 (the most recent year for which complete data are available), and nearly all of them claimed a deduction for state and local taxes paid (see Figure 1). State and local income taxes and real estate taxes made up the majority of the state and local tax deductions claimed, constituting 55 percent and 39 percent of the total, respectively. Deductions for sales taxes were about 4 percent of the total, and personal property taxes were just over 1 percent (see Figure 2).

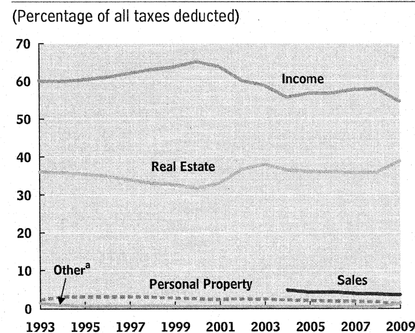
Over the next few years, scheduled changes to tax provisions and the interaction of the regular income tax and the alternative minimum tax will change the number of taxpayers who claim the deduction and the associated loss of federal revenues. (The AMT is a parallel income tax system with fewer exemptions, deductions, and tax rates than the regular income tax. Taxpayers potentially subject to the AMT must calculate their taxes under both the regular income tax and the AMT and pay the higher amount.)

Under current law, the amount of the loss of federal revenues is projected to diminish in 2012 because more taxpayers will pay the AMT, which does not allow people to claim the taxes-paid deduction. The number of taxpayers subject to the AMT will rise under current law because

Figure 2.

Types of Taxes Claimed Under the Taxes-Paid Deduction, 1993 to 2009

(Percentage of all taxes deducted)



Source: Congressional Budget Office based on data from the Internal Revenue Service.

Note: The taxes-paid deduction allows taxpayers to deduct from their adjusted gross income some of the taxes they pay to state and local governments, including income, real estate, personal property, and other taxes. From 2004 to 2009, taxpayers had the option to deduct general sales taxes in lieu of income taxes.

a. "Other" in 2009 includes the sales tax deduction for purchases of new vehicles.

temporarily higher AMT exemption amounts expired at the end of 2011. Without changes in the tax code—such as additional increases in the AMT exemption level like those enacted in recent years—more and more taxpayers will pay the AMT over time as their income grows.

The scheduled expiration after 2012 of tax provisions originally enacted in 2001 and 2003 will raise regular income tax rates for many taxpayers, boosting the value of the taxes-paid deduction for those who claim it and increasing the associated revenue loss for the federal government. With the higher tax rates for the regular income tax, many taxpayers will move from being subject to the AMT back to being subject only to the regular income tax—under which they are permitted to claim the deduction for state and local taxes. Those shifts will further increase the number of taxpayers claiming the taxes-paid deduction and the associated revenue loss.

Impact on State and Local Taxes and Spending

The taxes-paid deduction, which has been in place in some form since the inception of the modern federal income tax, benefits the taxpayers who claim it and provides an indirect federal subsidy to the state and local governments that levy deductible taxes—because it decreases the net cost to taxpayers of paying those taxes. By lowering the net cost of certain state and local taxes, the taxes-paid deduction encourages state and local governments to impose higher taxes and to provide more services than they otherwise would.

Two competing factors are the basis of the principal arguments in favor of and opposed to the deduction: on the one hand, the federal government's interest in assisting state and local governments in providing public services that have benefits beyond their borders and, on the other hand, the possibility that such assistance may generate an inefficiently large volume of services that are strictly local in nature.

If deductible taxes are simply charges that cover the value of services desired by taxpayers who have chosen to live in a particular state or local community, the rationale for subsidizing those services at the federal level is weak (unless localities face significant differences in the cost of providing services). For example, to better suit their preferences for street lights, parks, and even public safety, citizens may sort themselves into different communities that provide different amounts of those services. It is not evident why the federal government should subsidize those citizens who prefer to consume more of such services. In fact, the original legislation enacting the federal income tax explicitly labeled as nondeductible local taxes paid in return for local benefits.

Some deductible taxes, though, are clearly not charges for services that provide only local benefits but instead finance services, such as public assistance and education, that provide benefits that "spill over" to people in other states and localities. Such spillovers provide a rationale for federal support. Another rationale for federal support is that state income taxes are generally considered to have a redistributive function, although the extent to which they redistribute income varies widely and is small relative to the redistributive capacity of the federal income tax.

Three other points merit consideration. First, the taxes-paid deduction may simply encourage state and local governments to use deductible taxes in place of nondeductible taxes (levies such as selective—rather than general—sales taxes) without increasing spending for the desired activities. If so, the subsidy does not effectively encourage those governments to provide services that generate national benefits. A number of studies show that deductibility affects the mix of taxes that states and localities choose for financing their activities, but there is relatively little evidence that deductibility increases spending for services.[22]

Second, a common argument for allowing taxpayers to deduct state and local taxes is that such a deduction prevents double taxation of income. The contention is

22. Martin S. Feldstein and Gilbert E. Metcalf ("The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," *Journal of Political Economy*, vol. 95, no. 4 [1987], pp. 710–736) find that among a cross-section of states, deductibility raises the share of revenues that subsidized taxes make up but has no consistent effect on spending. Douglas Holtz-Eakin and Harvey S. Rosen ("Tax Deductibility and Municipal Budget Structure," in Rosen, ed., *The Fiscal Behavior of State and Local Governments: Selected Papers of Harvey S. Rosen* [Lyme, N.H., Elgar, 1997], pp. 43–72) document a similar effect, smaller but more precisely measured. Gilbert E. Metcalf ("Tax Exporting, Federal Deductibility, and State Tax Structure," *Journal of Policy Analysis and Management*, vol. 12, no. 1 [1993], pp. 109–126), using data on the states from 1980 to 1988, finds that the income tax share of taxes is sensitive to the subsidy from deductibility but the sales tax share is not. Holtz-Eakin and Rosen ("Federal Deductibility and Local Property Tax Rates," *Journal of Urban Economics*, vol. 27, no. 3 [1990], pp. 269–284), using a sample of municipal governments from 1976 to 1980, find that deductibility increases local property tax rates.

that resources claimed as taxes by state and local governments are not truly available to taxpayers and thus should not be considered part of the basis for federal taxation. In fact, that argument involves some of the same issues just discussed. If state and local taxes are benefit charges and reflect the amount of state and local public services that taxpayers desire and receive from their governments, then such taxes are appropriate to include in the basis for a levy that rests on the concept of people's ability to pay. Alternatively, if state and local taxes finance services whose benefits spill over to other localities, then the federal subsidy may be justified regardless of the issue of double taxation.

Third, another argument for the taxes-paid deduction involves its effect on marginal tax rates (that is, the tax rate on the last dollar of income). By reducing the combined federal, state, and local marginal tax rate on income, the deduction lessens the deterrent to earning income that is inherent in high tax rates. But that reduction in the distortion to choices by individuals (choices between work and leisure) is achieved by an increase in the distortion to choices by state and local governments (choices between deductible and nondeductible taxes and choices about the kinds and amounts of services the governments provide). The overall effects and the extent to which choices are distorted by the various incentives depend on the behavior of individuals and governments.

Distribution of Benefits by State

How benefits from the taxes-paid deduction are distributed among states and localities depends on the structure of governments' tax systems and the characteristics of the taxpayers who provide revenues to those governments. For example, a state or local government that finances its spending by using a larger share of taxes that are deductible under the federal individual income tax receives a larger subsidy through the deductibility provision than does an otherwise identical government that finances its spending through a smaller share of deductible taxes. In addition, a state or local government whose taxpayers are more likely to itemize deductions also gains a greater benefit, all else being equal, than does a government whose taxpayers tend to claim the standard deduction.

How much of state and local governments' revenues drawn from their own sources are subsidized through the taxes-paid deduction? A starting point for estimating that subsidy is assessing the share of all revenues collected by state and local governments from taxes that the federal tax code labels as deductible. That measure exceeds the amount of the subsidy in two respects: Taxpayers do not claim all legally deductible taxes on their returns (because not all taxpayers itemize and because the deduction is limited for some taxpayers), and the subsidy does not equal the total amount deducted but is the resulting reduction in federal tax revenues.

In 2004, taxes made up about 50 percent of states' "own-source" revenues.[23] The potentially deductible portion of those taxes was about 17 percent of such revenues; shares ranged from a low near zero in Alaska to highs near 40 percent in Washington and Tennessee. Revenues from direct federal transfers—constituting just under 24 percent of revenues from all sources—made up a larger share of states' total revenues than did potentially deductible taxes.

State governments tend to raise most of their tax revenues from income and sales taxes, but local governments depend primarily on property taxes for revenues. In 2004, about 38 percent of localities' own-source revenues came from property taxes and another 2 percent came from income taxes, both of which are potentially deductible. Although the potentially deductible share of localities' own-source revenues therefore averaged 40 percent, shares varied widely across the country—ranging from about 15 percent for localities in Alabama and Arkansas to about 75 percent for those in New Hampshire and New Jersey.

Using the share of own-source revenues raised by potentially deductible taxes to assess the benefits that state and local governments receive from the deductibility provision does not account for differences in the percentage of residents' total income that different governments collect as own-source revenues. For example, a state government that collects in revenues a larger share of its residents' total income receives a larger federal subsidy than does a state government that has the same share of its revenues derived from potentially deductible taxes but that has a lower overall revenue burden. However, potentially deductible taxes as a share of state and local governments' own-source revenues and as a share of the total income of state residents are fairly well correlated. That correlation suggests that most of the variation among states in the subsidy attributable to the deductibility provision results

23. See Congressional Budget Office, *The Deductibility of State and Local Taxes*.

from differences in the mix of taxes that the governments choose rather than from differences in their overall tax burdens.

Considering the states on a regional basis reveals a few general patterns about the distribution of potentially deductible taxes. The share of own-source revenues represented by potentially deductible taxes and the share of taxpayers' total income represented by such taxes tends to be larger in the Northeastern states. States in the South and Southwest—with the exception of Florida and Texas in the years when the sales tax was a potentially deductible tax—tend to have smaller shares of potentially deductible taxes by either measure.

The amount of potentially deductible taxes that are ultimately deducted on individuals' tax returns depends on whether those taxpayers itemize their deductions or take the standard deduction. Taxpayers with higher income tend to have both more itemized deductions apart from that for state and local taxes and higher state and local taxes; they are therefore are more likely to have itemized deductions that exceed the standard deduction (which does not vary by income or state) and to choose to itemize. Thus, states with taxpayers whose average income is comparatively high will have a larger share of taxpayers who itemize deductions. The states in which taxpayers claim the largest shares of the deduction are states with large populations and, in particular, large populations of high-income itemizing taxpayers. The percentage of taxpayers who itemize is highest in New England, the Middle and South Atlantic regions, and the Mountain and Pacific regions (see Table 2). Taxpayers in the Middle Atlantic and Pacific regions claim the largest percentages of total deductions.

For taxpayers, one indicator of the benefit provided by the taxes-paid deduction is how much the deduction reduces their income subject to taxation—specifically, the percentage deduction from their AGI. CBO estimated such benefits by state for 2009 by dividing the total deductions taken by residents of a state by the total AGI in that state. CBO further divided those figures by the average of the share of the AGI deducted in all states; residents of states that have relative shares above 1 have a larger percentage deduction from AGI than the national average, and residents of states that have relative shares below 1 have a smaller percentage deduction than the national average. According to that measure, taxpayers in the Middle Atlantic region, southern New England, and the Far West benefit most from the deduction, a geographic distribution that corresponds more closely to the distribution of high-income taxpayers among the states than to the distribution of potentially deductible taxes among the states.

The interaction between taxpayers' incomes and state and local tax burdens also influences how the benefits from the taxes-paid deduction are distributed among the states. Although taxpayers in states that have a large percentage deduction from AGI tend to claim larger deductions at all income levels than do taxpayers in states that have a small percentage deduction, the difference in claimed deductions increases as income rises. That is, the difference between the claimed deductions of taxpayers in large-share states and small-share states is greatest for the highest-income taxpayers. That finding implies that the benefits from the deductibility provision depend on the progressivity of state and local taxes as well as their average level.

Distribution of Benefits by Income Groups

High-income households are more likely than low- or moderate-income households to benefit from the taxes-paid deduction. The probability that taxpayers will itemize, the amount of state and local taxes paid, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income.

Individuals who choose to itemize and deduct the state and local taxes they have paid decrease their federal tax liability by the amount of their deductible state and local taxes multiplied by their marginal tax rate under the individual income tax. Because the likelihood of itemizing and the marginal tax rate increase with income, taxpayers who benefit from the taxes-paid deduction in its current form are concentrated in the upper part of the income distribution.

Slightly less than one-third of all tax filers deducted state and local taxes in 2009, and the percentage claiming the deduction varied widely among income groups. Approximately 25 percent of tax filers with income less than $100,000 took the deduction, compared with about 87 percent of tax filers with income of $100,000 or more. The latter group, who made up roughly 12 percent of filers, accounted for 64 percent of the value of all state and local tax deductions claimed, with an average of about $18,300 in deductible taxes for each return on which the deduction was claimed.

The tax saving from each dollar of the taxes-paid deduction increases with income because of the progressivity of federal income tax rates. In general, under the individual income tax, the higher a taxpayer's income is, the higher will be his or her marginal tax rate and therefore the larger the reduction in federal tax liability gained from deducting an additional dollar of state or local tax. According to CBO's estimates, in 2009 approximately 73 percent of the tax benefit of the taxes-paid deduction accrued to taxpayers with income above $100,000. Among those with income above $100,000, taxpayers with income between $100,000 and $200,000 received just under 35 percent of the total benefit, and taxpayers with income of more than $1 million received slightly more than 20 percent of the benefit.

Policy Options

When policymakers discussed major tax reform in the 1980s, one of the many proposals they considered was the elimination of the deduction for state and local taxes paid. The Tax Reform Act of 1986, the outcome of those deliberations, repealed only the deduction for general sales taxes.

The Omnibus Budget Reconciliation Act of 1990 enacted a general limit on itemized deductions under which certain itemized deductions—including that for state and local taxes—were reduced by 3 percent of the amount by which a taxpayer's adjusted gross income exceeded an indexed threshold, with a maximum reduction of 80 percent of deductible expenses. However, that limit has since been rolled back. The Economic Growth and Tax Relief Reconciliation Act of 2001 gradually phased out the limit and completely eliminated it by 2010, and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the elimination of the general limit on itemized deductions through 2012. Without further changes in law, the general limit will again apply beginning in 2013.

In addition, the American Jobs Creation Act, enacted in 2004, reinstated the sales tax deduction that the Tax Reform Act of 1986 had eliminated. The 2004 law allowed taxpayers to deduct either income taxes or sales taxes—but not both—in 2004 and 2005. (Before the change enacted in 1986, taxpayers could deduct both income taxes and general sales taxes.) Subsequent legislation extended that provision to 2006 and 2007, and then through 2009, and then again through 2011.

In its 2011 report on options for reducing the deficit, CBO considered two options for changing the taxes-paid deduction: eliminating the deduction and limiting the deduction to 2 percent of adjusted gross income.[24]

The options would have the following estimated effects relative to the outcomes under current law:

- Eliminating the deduction would increase federal revenues by an estimated $862 billion from 2012 through 2021, and limiting the deduction to 2 percent of AGI would increase revenues by an estimated $629 billion over the same period.[25] Both options would have the greatest impact on higher-income taxpayers, particularly in 2013. In 2012, eliminating the taxes-paid deduction would increase taxes for 48 percent of tax filers with income of $100,000 or more (approximately 12 percent of all tax filers in 2012), but in 2013 it would have that effect for 76 percent of those tax filers (under an assumption that the tax rate reductions originally enacted in 2001 and 2003 expire as scheduled). By comparison, limiting the deduction to 2 percent of AGI would raise taxes for 44 percent of taxpayers with income between $50,000 and $100,000 in 2012 and for 49 percent of such taxpayers in 2013.
- Eliminating the taxes-paid deduction would produce the largest decrease in average income measured after individual income taxes (after-tax income) for taxpayers with income of $500,000 or more. For example, under that option, average after-tax income in 2012 would fall by 1.3 percent for taxpayers whose income was between $500,000 and $1 million and by 1.7 percent for taxpayers whose income was $1 million or more. After-tax income for those groups would fall even more in 2013, after the tax rate reductions originally enacted in 2001 and 2003 expired, by 2.9 percent and 2.7 percent, respectively.

24. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, pp. 148–149. The CBO report *The Deductibility of State and Local Taxes* considers additional options, including replacing the deduction with a 15 percent credit. The 2005 President's Advisory Panel on Federal Tax Reform recommended the complete elimination of the deduction.

25. Estimates of the options' effects on federal revenues were provided by the staff of the Joint Committee on Taxation.

Table 2.

Selected Measures of State and Local Tax Deductibility, 2009

	Percentage of Taxpayers Who Itemized	Percentage of Total Deductions Claimed	Average Taxes-Paid Deduction per Return Claiming the Deduction (Dollars)	Percentage of AGI Deducted	Ratio of Deduction Share to AGI Share
By State					
Alabama	29.4	1.0	5,117	3.2	0.84
Alaska	25.8	0.2	4,332	1.9	0.60
Arizona	35.6	1.9	6,282	4.4	1.10
Arkansas	24.6	0.5	7,240	3.9	0.78
California	37.2	16.6	12,486	7.6	1.30
Colorado	39.2	1.8	6,840	4.5	1.05
Connecticut	44.0	2.0	14,863	8.2	1.12
Delaware	36.3	0.3	7,170	4.6	0.96
District of Columbia	40.8	0.3	12,683	6.9	1.09
Florida	28.9	5.2	5,934	3.3	0.89
Georgia	37.1	3.0	7,333	5.6	1.12
Hawaii	32.5	0.5	7,116	4.5	1.12
Idaho	33.2	0.4	6,772	4.9	1.05
Illinois	34.4	4.1	9,269	5.4	0.92
Indiana	27.0	1.3	6,810	3.9	0.74
Iowa	30.6	0.7	7,779	4.7	0.80
Kansas	30.2	0.7	8,840	5.1	0.85
Kentucky	28.8	0.9	7,914	5.0	0.84
Louisiana	24.2	0.9	6,347	3.1	0.75
Maine	30.6	0.3	9,307	6.1	0.90
Maryland	49.1	3.3	11,097	8.1	1.39
Massachusetts	40.1	2.9	11,720	6.8	1.03
Michigan	32.2	2.5	7,876	5.3	0.91
Minnesota	39.6	2.0	9,286	6.4	1.05
Mississippi	24.0	0.5	5,569	3.2	0.80
Missouri	30.3	1.5	7,727	4.7	0.87
Montana	30.2	0.3	6,934	4.6	0.93
Nebraska	29.8	0.5	8,810	5.2	0.84
Nevada	33.4	0.9	5,071	3.1	1.06
New Hampshire	35.8	0.5	8,283	4.9	1.00
New Jersey	43.9	4.6	14,655	9.1	1.19
New Mexico	25.8	0.4	5,704	3.3	0.79
New York	36.6	8.8	16,897	9.3	1.14
North Carolina	34.8	2.7	8,124	5.8	1.05

Continued

- Eliminating the deduction would have a small effect on taxpayers with income between $50,000 and $100,000; their after-tax income would drop by about 0.7 percent in 2012 and 2013. The reduction in after-tax income for income groups below $50,000 would be 0.3 percent or less.
- Under both of the options, the change in after-tax income for taxpayers who pay the AMT would be quite different in 2012 from the change in 2013. For example, eliminating the taxes-paid deduction would decrease the average after-tax income of taxpayers whose income was between $200,000 and $500,000 by only 0.3 percent in 2012. Most taxpayers in that

Table 2. Continued

Selected Measures of State and Local Tax Deductibility, 2009

	Percentage of Taxpayers Who Itemized	Percentage of Total Deductions Claimed	Average Taxes-Paid Deduction per Return Claiming the Deduction (Dollars)	Percentage of AGI Deducted	Ratio of Deduction Share to AGI Share
By State (Continued)					
North Dakota	19.7	0.1	6,710	2.5	0.52
Ohio	30.8	2.8	8,565	5.5	0.85
Oklahoma	27.0	0.8	6,547	3.6	0.80
Oregon	39.8	1.4	9,095	7.2	1.28
Pennsylvania	30.5	3.5	9,237	5.2	0.84
Rhode Island	36.7	0.4	10,446	7.1	1.03
South Carolina	30.8	1.2	6,977	4.8	1.00
South Dakota	19.5	0.1	4,787	1.9	0.57
Tennessee	24.2	1.2	4,546	2.3	0.74
Texas	25.1	5.3	6,704	3.0	0.70
Utah	39.5	0.9	6,513	4.9	1.19
Vermont	29.7	0.2	9,667	5.9	0.98
Virginia	40.9	3.3	9,229	5.9	1.10
Washington	35.7	2.2	6,092	3.6	0.94
West Virginia	18.4	0.3	7,772	3.2	0.57
Wisconsin	35.7	1.8	9,918	6.9	0.99
Wyoming	24.7	0.1	4,729	1.9	0.65
All States	**35.2**	**100.0**	**6,767**	**5.4**	**1.00**
By Census Division					
New England	39.1	6.2	11,968	7.0	1.04
Middle Atlantic	36.3	16.9	14,293	8.2	1.07
South Atlantic	38.7	19.5	7,972	5.2	1.05
East north central	32.2	12.6	8,617	5.4	0.89
East south central	26.6	3.7	5,709	3.3	0.80
West north central	32.0	5.6	8,395	5.1	0.88
West south central	25.1	7.6	6,684	3.1	0.72
Mountain	35.0	6.8	9,439	4.2	1.04
Pacific	35.9	21.2	11,064	6.7	1.20

Source: Congressional Budget Office based on data from the Internal Revenue Service.

Notes: The taxes-paid deduction allows taxpayers to deduct from their adjusted gross income some of the taxes they pay to state and local governments, including income, real estate, personal property, and other taxes. In 2009, taxpayers had the option to deduct general sales taxes in lieu of income taxes.

AGI = adjusted gross income.

income range will pay the AMT this year under current law and thus will not be able to claim the taxes-paid deduction. In 2013, when tax reductions enacted in 2001 and 2003 are currently scheduled to have expired, many taxpayers with income between $200,000 and $500,000 will shift from being subject to the AMT to being subject to only the regular income tax—under which they may claim the deduction. Eliminating the taxes-paid deduction would reduce the average after-tax income of taxpayers in that income range by 1.4 percent in 2013.

The effects of any changes to the taxes-paid deduction would depend critically on any future changes to the

AMT. CBO analyzed each of the options under the assumption that current law would remain in place (that is, the AMT exemption amounts would revert to their pre-2001 levels in 2012 and would not be indexed for inflation). Because the deduction for state and local taxes is the largest item (for taxpayers considered altogether) that must be added back to income under the AMT, lawmakers' choices regarding the AMT would substantially affect the revenues derived from those options.

Under current law, the number of taxpayers who pay the AMT will grow each year because the exemption amounts and AMT tax brackets are not indexed for inflation. As the scope of the AMT expands, fewer people will benefit from the deduction for state and local taxes. However, policymakers have routinely increased the AMT exemption amount, and if that happened again in the future, fewer taxpayers would be subject to the AMT, and, consequently, more could claim the deduction for state and local taxes. In that case, the revenues gained from eliminating the deduction would be larger than those under current law.

In an analysis several years ago, CBO considered the combined effects under current law of permanently raising and indexing the AMT exemption levels and indexing the AMT while also eliminating the deduction for state and local taxes.[26] The results at that time indicated that the gain in revenues from eliminating the deduction would more than offset the loss in revenues from indexing the AMT. The gain from eliminating the deduction would be smaller, however, if the lower regular income tax rates originally enacted in 2001 and 2003 were permanently extended.

26. See Congressional Budget Office, *The Deductibility of State and Local Taxes* (February 2008). That report also considered the combined effects of indexing the AMT and additional options for limiting, rather than eliminating, the taxes-paid deduction.

Senate Finance Committee Hearing
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
April 25th, 2012
Questions for Mr. Frank Sammartino

Questions from Chairman Baucus

1. Currently, tax laws provide a deduction for State and local taxes. Should these deductions be eliminated or limited as part of tax reform? Why or why not?

   What's the benefit to the federal government for these provisions being a part of the federal tax system?

   Is it fair that only taxpayers that itemize their deductions get the benefit of the deduction for State and local taxes?

Answer:

Two competing arguments are often given in favor of and opposed to the federal deduction for state and local taxes: on the one hand, the federal government's interest in assisting state and local governments in providing public services that have benefits beyond their borders and, on the other hand, the possibility that such assistance may generate an inefficiently large volume of services that are strictly local in nature. If deductible taxes are simply charges that cover the value of services desired by taxpayers who have chosen to live in a particular state or local community, the rationale for subsidizing those services at the federal level is weak (unless localities face significant differences in the cost of providing services). For example, to better suit their preferences for streetlights, parks, and even public safety, citizens may sort themselves into different communities that provide different amounts of those services. It is not evident why the federal government should subsidize those citizens who prefer to consume more of such services. In fact, the original legislation enacting the federal income tax explicitly labeled as nondeductible local taxes paid in return for local benefits.

Some deductible taxes, though, are clearly not charges for services that provide only local benefits but instead finance services, such as public assistance and education, that provide benefits that "spill over" to people in other states and localities. Such spillovers provide a rationale for federal support. Another rationale for federal support is that state income taxes are generally considered to have a redistributive function, although the extent to which they redistribute income varies widely and is small relative to the redistributive capacity of the federal income tax. It is generally thought that redistributive programs are a federal responsibility because population mobility across regions can constrain similar state and local government programs.

Three other points merit consideration. First, the taxes paid deduction may simply encourage state and local governments to use deductible taxes in place of nondeductible taxes (levies such as selective—rather than general—sales taxes) without increasing spending for the desired

activities. If so, the subsidy does not effectively encourage those governments to provide services that generate national benefits. A number of studies show that deductibility affects the mix of taxes that states and localities choose for financing their activities, but there is relatively little evidence that deductibility increases spending for services.

Second, a common argument for allowing taxpayers to deduct state and local taxes is that such a deduction prevents double taxation of income. The contention is that resources claimed as taxes by state and local governments are not truly available to taxpayers and thus should not be considered part of the basis for federal taxation. In fact, that argument involves some of the same issues just discussed. If state and local taxes are benefit charges and reflect the amount of state and local public services that taxpayers desire and receive from their governments, then such taxes are appropriate to include in the basis for a levy that rests on the concept of people's ability to pay. Alternatively, if state and local taxes finance services whose benefits spill over to other localities, then the federal subsidy may be justified regardless of the issue of double taxation.

Third, another argument for the taxes-paid deduction involves its effect on marginal tax rates (that is, the tax rate on the last dollar of income). By reducing the combined federal, state, and local marginal tax rate on income, the deduction lessens the deterrent to earning income that is inherent in high tax rates. But that reduction in the distortion to choices by individuals (choices between work and leisure) is achieved by an increase in the distortion to choices by state and local governments (choices between deductible and nondeductible taxes and choices about the kinds and amounts of services the governments provide). The overall effects and the extent to which choices are distorted by the various incentives depend on the behavior of individuals and governments.

High-income households are more likely than low or moderate-income households to benefit from the taxes-paid deduction. The probability that taxpayers will itemize, the amount of state and local taxes paid, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income. Individuals who choose to itemize and deduct the state and local taxes they have paid decrease their federal tax liability by the amount of their deductible state and local taxes multiplied by their marginal tax rate under the individual income tax. Because the likelihood of itemizing and the marginal tax rate increase with income, taxpayers who benefit from the taxes-paid deduction in its current form are concentrated in the upper part of the income distribution. Slightly less than one-third of all tax filers deducted state and local taxes in 2009, and the percentage claiming the deduction varied widely among income groups. Approximately 25 percent of tax filers with income less than $100,000 took the deduction, compared with about 87 percent of tax filers with income of $100,000 or more. The latter group, who made up roughly 12 percent of filers, accounted for 64 percent of the value of all state and local tax deductions claimed, with an average of about $18,300 in deductible taxes for each return on which the deduction was claimed.

The tax saving from each dollar of the taxes-paid deduction increases with income because of the progressivity of federal income tax rates. In general, under the individual income tax, the higher a taxpayer's income is, the higher will be his or her marginal tax rate and therefore the larger the reduction in federal tax liability gained from deducting an additional dollar of state or local tax. According to CBO's estimates, in 2009 approximately 73 percent of the tax benefit of the taxes-

paid deduction accrued to taxpayers with income above $100,000. Among those with income above $100,000, taxpayers with income between $100,000 and $200,000 received just under 35 percent of the total benefit, and taxpayers with income of more than $1 million received slightly more than 20 percent of the benefit.

Questions from Senator Hatch

1. Currently most taxpayers who itemize have the choice of deducting certain taxes paid to state and local municipalities. Currently deductions are allowed for state and local real property, personal property, state sales, and income taxes.

   The Joint Committee on Taxation estimates that the revenue loss to the Federal government from 2011 to 2015 of these deductions will be $347 billion, if it is extended for that time. As Mr. Sammartino notes, "By lowering the net cost of those state and local taxes, the taxes-paid deduction encourages state and local governments to impose higher taxes..."

   My question is, how much do these deductions subsidize state and local governments? We know what the revenue loss is to the federal government, but even if one is comfortable subsidizing state government, is this a good way to do it?

Answer:

The taxes-paid deduction, which has been in place in some form since the inception of the modern federal income tax, benefits the taxpayers who claim it and provides an indirect federal subsidy to the state and local governments that levy deductible taxes—because it decreases the net cost to taxpayers of paying those taxes. By lowering the net cost of certain state and local taxes, the taxes-paid deduction encourages state and local governments to impose higher taxes and to provide more services than they otherwise would.

A starting point for estimating how much of state and local governments' revenues are subsidized through the taxes-paid deduction is assessing the share of all revenues collected by state and local governments from taxes that the federal tax code labels as deductible. That measure exceeds the amount of the subsidy in two respects: Taxpayers do not claim all legally deductible taxes on their returns (because not all taxpayers itemize and because the deduction is limited for some taxpayers), and the subsidy does not equal the total amount deducted but is the resulting reduction in federal tax revenues.

In 2004, taxes made up about 50 percent of states' "own-source" revenues.[1] The potentially deductible portion of those taxes was about 17 percent of such revenues; shares ranged from a low near zero in Alaska to highs near 40 percent in Washington and Tennessee. State governments tend to raise most of their tax revenues from income and sales taxes, but local governments depend primarily on property taxes for revenues. In 2004, about 38 percent of

[1] Own-source revenues are all revenues not received from another government or from government-run utilities, liquor stores, or insurance funds. Charges such as fees for education and hospitals make up most of the nontax portion of own-source revenues.

localities' own-source revenues came from property taxes and another 2 percent came from income taxes, both of which are potentially deductible. Although the potentially deductible share of localities' own-source revenues therefore averaged 40 percent, shares varied widely across the country—ranging from about 15 percent for localities in Alabama and Arkansas to about 75 percent for those in New Hampshire and New Jersey.

One of the criteria for evaluating whether a federal subsidy is an efficient use of scarce federal resources is the national benefits that it provides. If the taxes-paid deduction encourages state and local governments to use deductible taxes to fund additional services that create spillover benefits to other regions of the country, then the deduction provides a benefit to the taxpayers across the country who finance the deduction. If the deduction does not prompt states or localities to change their behavior in that way, or if they use deductible taxes in place of nondeductible levies and do not offer additional services with spillover benefits, then the deduction is not providing that same benefit to taxpayers across the country. A number of studies show that deductibility affects the mix of taxes that states and localities choose for financing their activities, but there is relatively little evidence that deductibility increases spending for services.

2. President Obama has proposed to dramatically reduce the charitable deduction in his latest budget, as well as previous budgets. He does so by proposing to take away up to 29% of itemized deductions for families that are in either of the top two income tax brackets. This will reduce charitable giving. Charity should be the last thing that the President is attacking.

   The President is also going after the ability of families and individuals to exclude interest on tax-exempt bonds from their income. This question is for the whole panel.

   Yes or no—do you agree with me that the President's proposal will increase borrowing costs for state and local governments? Please explain.

Answer:

Under current law, individual taxpayers may reduce their taxable income by excluding certain types or amounts of income, including interest from state and local government bonds; as a result, such bonds are often known as tax-exempt bonds. The tax reduction from the last dollar of income excluded is $1.00 times the taxpayer's marginal income tax rate, where the marginal rate is the tax rate on the last dollar of income. For example, the value of excluding the last dollar of tax-exempt interest is 35 cents for a taxpayer in the 35 percent tax bracket. President Obama has proposed limiting the tax value of specified deductions and exclusions, including the exclusion of interest from state and local bonds, to 28 percent.

CBO has not closely studied the effect of the President's proposal on state and local borrowing costs, but some rough calculations suggest that state and local borrowing costs would not be affected very much by a 28 percent cap.[2] Specifically, taxpayers in the 28 percent and lower tax

[2] The President's FY2013 budget includes other proposals that would have an impact on the market for state and local debt, most notably the proposal to expand and make permanent the Build America Bond (BAB) program

brackets would not be affected by the cap, while taxpayers in higher tax brackets would still find it advantageous to purchase tax-exempt bonds rather than comparable taxable bonds.

To understand that conclusion, begin with the point that the interest rate that state and local governments pay on tax-exempt bonds is the rate that matches the supply of those bonds with the demand for them, which is determined by the last buyer needed to equalize supply with demand and "clear" the market. All issuers of comparable tax-exempt debt (that is, debt that is comparable in its risk and other characteristics) pay that interest rate. Because purchasers of tax-exempt bonds demand a return that is at least as high as the after-tax yield they could obtain from comparable taxable bonds, the amount by which the federal tax preference lowers the rate of interest on tax-exempt bonds—and thus the amount of savings in financing costs enjoyed by state and local governments—largely depends on the income tax rate of the market-clearing buyer of tax-exempt bonds.

Data on tax-exempt and taxable bond transactions allow a rough estimate of the marginal tax rate for the market-clearing buyer of tax-exempt bonds and, hence, the amount that states and localities save in financing costs by issuing such bonds. In 2009, the average yield on (taxable) high-grade corporate bonds was 5.3 percent, and the average yield on tax-exempt municipal bonds of similar creditworthiness was 4.6 percent—a difference of 0.7 percentage points, or approximately 13 percent of the taxable return. That 13 percent also represents the marginal tax rate at which an investor would be indifferent between purchasing a taxable bond yielding 5.3 percent and a tax-exempt bond yielding 4.6 percent. The implicit tax rate for market-clearing buyers of tax-exempt bonds from 2008 to 2010 ranged from 13 percent to 16 percent, considerably lower than the average of 21 percent during the prior two decades. Investors' appetite for risk, the desired time horizon of their investments, and other features of the bonds can also influence the demand for taxable and tax-exempt debt.

Investors in tax brackets above the implicit tax rate for market-clearing buyers thus are able to purchase tax-exempt state and local bonds with yields that exceed the after-tax yields they receive from comparable taxable corporate bonds. For example, a taxpayer in the 35 percent bracket would be indifferent between a taxable corporate bond yielding 5.3 percent and a tax-exempt bond yielding about 3.5 percent—but could (in 2009) purchase tax-exempt debt yielding 4.6 percent. Even if the tax benefit was capped at 28 percent, tax-exempt bondholders in upper tax brackets would still receive after-tax yields on tax-exempt bonds that would be higher than the after-tax yields that would receive on comparable taxable bonds: At a 28 percent rate, a taxpayer would be indifferent between a taxable corporate bond yielding 5.3 percent and a tax-exempt bond yielding about 3.8 percent—which is still well below the 4.6 percent rate that such bonds were paying in 2009. Thus, because the market-clearing rate on tax-exempt bonds tends to be less than 28 percent below the rate on comparable taxable bonds, purchasing tax-exempt bonds would still be advantageous to bondholders in upper tax brackets even with a 28 percent cap.

(which was authorized for calendar years 2009 and 2010). In addition to allowing BABs to be issued for more purposes than under their initial authorization, the President proposes to provide a 30 percent interest subsidy to state and local borrowers in 2013, and 28 percent thereafter. The discussion in this response does not take into account how implementation of those other proposals would influence the borrowing costs of state and local governments that issue tax-exempt debt.

However, not all of the tax-exempt earnings of upper-bracket bondholders are necessarily in excess of the earnings necessary to induce those bond holders to hold the amount of tax-exempt bonds they hold. As the issuers of tax-exempt debt raise the yield on bonds to bring in potential buyers from lower tax brackets to clear the market, they may induce upper-bracket bondholders to buy even more bonds than they would have at a lower tax-exempt yield that left them indifferent between a tax-exempt and a taxable bond. Effectively, the federal government would be paying a premium to induce upper-bracket bondholders to adjust their investment portfolios to hold more tax-exempt debt. To the extent this is the case, a 28 percent cap would reduce the demand for tax-exempt bonds and raise the cost of borrowing for state and local governments. In CBO's judgment, this effect is probably small.

NATIONAL CONFERENCE OF **CPA** PRACTITIONERS

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My name is Sanford Zinman. I am a Certified Public Accountant, member of the American Institute of CPA's and am currently the National Tax Chair of the National Conference of CPA Practitioners, (NCCPAP), as well as the President of the Westchester / Rockland New York Chapter. NCCPAP is a professional organization that advocates on issues that affect Certified Public Accountants in public practice and their small business and individual clients located throughout the United States. NCCPAP members serve more than 500,000 businesses and individual clients and are in continual communication with regulatory bodies to keep them apprised of the needs of the local CPA practitioner.

Accompanying me is Mr. Edward Caine, Vice President of NCCPAP who is a CPA in the Philadelphia PA area with a practice similar to mine with clients throughout the United States and overseas.

I am the sole owner of a CPA firm in White Plains, New York which I started almost 30 years ago. I have been preparing individual and small business tax returns as well as sales tax and payroll tax returns for over 35 years. I regularly prepare several hundred income tax returns during any given year and am in the trenches with my clients discussing tax law changes, tax interpretation and projections for planning and estate tax purposes. Although my clients are mostly in the New York, New Jersey and Connecticut area I have many clients in Florida, Alabama, California, Massachusetts, Nebraska, Tennessee and Washington DC. In this respect my practice is the same as many members of NCCPAP and other CPA firms throughout the United States.

The issues regarding the impact of Federal tax provisions which provide benefits and detriments to the states are broad and wide ranging.

From a practical standpoint, or from the standpoint of a CPA professional who is dealing with taxpayer issues daily, there is a need to address the varied types of taxes and how they impact the taxpayer and the tax collector.

The types of taxes which impact taxpayers the most are: Income taxes of individuals and other entities, the related financial planning and estate planning issues faced by these individuals and other entities, employment taxes and State and local sales and use taxes.

Income Taxes of Individuals and Other Entities:

Multi State Residency Issues:

The issue of income tax for individuals with multi-state residency, especially for those who are retired, has grown in recent years. As the pre-baby boom generation is being joined with the beginning of the baby boomers, many of these individuals, married or single, are purchasing second (and in some cases, third) residences in other states and dividing their time between their residences. This poses a problem for these taxpayers–in which state do they declare residency? Currently this issue is not being decided by the individual, but by state tax laws. The state governments have become aggressive in seeking additional sources of revenue. This is not a recent event, but has been going on for many years. For example, the State of New York took a unique position on residency 20 years ago. If an individual sold their home and moved to a different state, cutting all ties with New York State, with one exception - their burial plot located in New York State, New York claimed that, because the plan was to return to the State, the individual would be required to file New York State Resident Income Tax Returns. When word of this came out, there was such uproar that the State of New York quickly reversed this position. Today, determination of residency is somewhat different. However, factors that will be considered in determining residency include, but are not limited to: the number of days spent in each state, where their prized possessions are located, where they are registered to vote, where their car is registered, where their primary care physicians are, and the size of their various residences. Many states are aggressively asserting that individuals

are residents to collect resident income tax, use tax and the all important estate tax. I have used New York and Florida as an obvious example but these multi-state issues are prevalent in many jurisdictions. There are Ohio-Florida, Colorado-Nevada transplants and many others.

Another factor that presents a problem for the aging segment of the population is that when taxpayers purchase a second residence in another state, often only one spouse will take the necessary steps for establishing residency in that state such as registering a second vehicle, and registering to vote in that state. This is often done to minimize real property taxes. The State of Florida has limits as to how much real property taxes can increase on a primary residence for Florida homesteaders. If however, that residence is not the primary residence, then the real property taxes can increase by greater amounts from year to year. This can lead to a problem with a surviving spouse who then passes.

As example: a couple from New York purchases a second residence in Florida. Spouse #1 declares Florida residency, gets a Florida driver's license, registers to vote in Florida, etc., while Spouse #2 remains a New York resident. Spouse #1 dies and Spouse #2 spends most of the next 20 years living in Florida, but never makes the changes with regard to their own residency. When Spouse #2 passes away, the estate of Spouse #2 has to file an estate tax return in New York. This is necessary even though, while alive for the past 20 years, Spouse #2 was not required to file in New York because the taxpayer was not living in New York. But for the technicality that the individual did not bother to make the necessary change to establish residency in Florida the executor now has to file an estate tax return in a state in which the individual did not live.

A taxpayer faces many tax complexities when relocating from state to state. For example, a couple just relocated from New Jersey to California in October of 2011. Their income includes self-employment income, interest, dividends, capital gain transactions, and rental property, and they have the usual gambit of itemized deductions. In order to properly prepare their state returns, all of the income and expense items need to be allocated between the two states. So the federal government includes 100% of all the items and the states require that each item on the return be allocated appropriately to the respective states. So, three Schedule C's reporting self-employment income were prepared, one for the

federal, one for NJ and one for CA. Three Schedule B's reporting interest and dividend income were prepared, etc.

Tax Treaties:

The United States government has income tax treaties with many countries. However, many of the states do not recognize these treaties, so a non resident alien may not be required to pay federal taxes under a treaty but the individual may be required to pay state taxes. Example: A New Jersey partnership with two partners from Israel sold its technology rights to an Israeli Corporation. The Israeli corporation pays royalties to the New Jersey partnership based on sales of the developed product. In accordance with the US/Israeli treaty, the Israeli partners pay U.S. federal tax on the royalty generated from the sale of product to U.S. customers only. As the State of New Jersey does not honor the tax treaty, the State imposes a tax, in this case, on 100% of the royalty paid worldwide.

Business Jurisdiction Issues:

I acknowledge that federal law should not usurp state law, but individuals are left to battle with each jurisdiction that wants a piece of the action and their tax dollars. This also happens with other entities. Businesses which have nexus in multiple jurisdictions are also potentially subject to double or triple taxation. Although all states will acknowledge that credits should be given for taxes paid to other jurisdictions, those credits will not be given if the state perceives that the tax paid to another jurisdiction is improper. This again leaves the taxpayer in the uncomfortable position of either risking a wrong move or overpaying taxes to avoid lengthy administrative hearings.

Alternative Minimum Tax:

And then there is dreaded Alternative Minimum Tax ("AMT"). The National Conference of CPA Practitioners has long advocated for the abolishment of the alternative minimum tax. More than being a regressive tax and a hardship on a

portion of the taxpaying public that was not the original target of this tax; the AMT disproportionately affects taxpayers in certain states and areas of the country. While it is clear that this was an unintended consequence of the law, Congress has been unable to address the elimination of this tax.

The tax practices of many of our members are, like my practice, comprised of couples who are earning very good salaries so they can afford to live in communities with high income and real estate taxes. As little as ten years ago, none of these individuals had to think about the AMT when they considered where to live and purchased their homes. Now, it is a regular discussion that is happening within many tax practitioners' offices. Many of these taxpayers are located in the New York metropolitan area because that is where they were able to find work. And, no, they are not all wealthy money managers or hedge fund traders. These taxpayers are often regular, middle-class working people; teachers, police officers, civil servants, executives and business owners. But the wages they must earn and the state and local taxes they must pay makes them subject to a 25 to 28% federal tax bracket. These same people would be paying a 15 to 20% federal tax rate if they lived in a lower taxed state and they would be living the same life style. But there is no consideration of regional or local cost of living standards within the AMT rules. So these middle class, two worker families trying to save for college for their kids are being hammered on their federal taxes. This problem only compounds itself because these taxpayers have to earn more to offset the extra federal tax burden. This is an area where federal policy could assist the states. In theory, if federal taxes were lowered for these taxpayers, their disposable net income would be increased and there might be fewer objections to state and local income and property taxes.

Financial Planning issues for Individuals, Estates and Businesses:

Having just discussed the problems faced by individuals related to the AMT, I would like to discuss how this and other tax issues affect the individual and business taxpayers. I will start with a background story.

One of my clients is an estate and elder law attorney who earns a good living, works in one state and lives in another. Last year, just after I had completed his 2010 tax return, he asked me to help him plan for 2011. He wanted to know what I thought was going to happen with tax rates, AMT and specific items such as bonus depreciation and Internal Revenue Code section 179. My response was in the form of a question. I asked him what the estate tax exemption was going to be in 2012 and 2013 and if there would still be a tie in with the gift taxes. We agreed that we knew very little about the near future changes of tax law. How can someone plan to pay the correct amount of tax to the federal government (and even the state) in April or June or even September when, all too often, no one knows what will happen until December. This uncertainty is a recipe for disaster.

Similarly there are many practical issues that tax preparers face when preparing income tax returns that are the result of legislation enacted in November or December. An example of this is Form 8949 – Sales and Other Dispositions of Capital Assets.

This issue arose very late in the year and has caused concern and, at times, an extra burden within the tax preparer community and amongst the taxpayers themselves.

Many financial advisors have written to their clients advising them that the return preparer should note that the cost basis of their stock sales was incorrectly calculated regardless of whether this is or is not true. That is easy for the financial advisors to write because they are not signing the returns as true and correct. However, this is also a correct statement since the advisors were often unable to receive the transaction information within a reasonable time frame to determine if all the trades were properly recorded. This has placed additional burden on the taxpayers and tax preparers and will impact the Internal Revenue Service when these returns are audited. The brokerage houses must generate and provide corrected 1099 forms to taxpayers (sometimes after the filing deadline). Taxpayers must then file amended income tax returns. Until the modernized e-

file system is completely operational, the taxpayer must file the federal and respective state returns on paper and the Internal Revenue Service and State service centers must process the amended tax return manually. This causes an additional burden on all.

Employment Taxes:

Workforce mobility is here to stay. Workers travel to different states either to find new work or better pay or because they are temporarily reassigned to a different location by their employers. Federal law recognizes this mobility and offers individuals and entities incentives to insure that workers can keep working and companies can keep good workers. However, state and local employment laws and regulations vary greatly from state to state. In addition, there is no uniform definition of which types of workers are employees and which are independent contractors. Even within states, there are different definitions of who is an employee for withholding tax, unemployment insurance, worker's compensation insurance and other employment related taxes. Connecticut employers who are also Massachusetts employers must be very careful about the employment laws within each state in determining if a recipient of money is an employee or an independent contractor. In most, if not all states, federal guidelines do not control the state determination of employment status. Equally important, employee wage reporting requirements vary widely from state to state causing difficulty for small employers who are preparing employee W-2 forms. Individual employee issues are addressed separately. As indicated, the federal government should not be attempting to usurp state rights or jurisdictional standing, but, to help promote more business activities; the federal government must assume a more active role in the administration of employment taxes and encourage a uniform definition of who is an employee. The Treasury department regulations on the uniform definition of a qualifying dependent have gone a long way to resolving the related income tax issues. A similar effort on who is an employee would be extremely helpful and would do a lot to level the playing field for employers.

Sales and Use Taxes:

Sales and use tax issues significantly affect state and local governments. Over the past several years, in an effort to increase revenues, states have increased their collection efforts. By the end of 2011 eight states have enacted click-through nexus provisions and more than fifteen states have proposed laws expanding sales tax nexus. Based on the Supreme Court decision in the Quill case there has been the requirement of a physical presence in the state before that state could assert nexus. The states have begun to look for any connection that an out-of-state seller might have that could be construed as a physical presence and some states have enacted legislation imposing a sales tax liability on internet companies if the company has agents in the state. With the explosion of internet sales states are now looking at ways to expand the range of activities which creates nexus. One can look at the recent Overstock.com and Amazon.com cases to see the trend of state regulations and the pursuit of lost sales and use tax revenue. Additionally, many states are now requiring individuals to report use tax on taxable items purchased out of state on their state income tax returns in an effort to reclaim some of the lost revenue.

While most people understand the need for separation of federal and state governments, it is apparent that there is a loss of sales tax revenue due to cross border sales. It should also be obvious that this represents a loss of revenue to brick and mortar small business retailers who have a physical presence in a state but are not big enough to be a multi state retailer. In areas where state borders are nearby, companies may choose to establish their offices in one state just so they can sell in another and may deliberately run their business in a specific way to avoid the sales tax collection issues. Often businesses look to establish themselves in sales tax friendly states with the ability to sell to neighboring jurisdictions and to avoid collecting and paying sales tax to the destination state. I have had experiences with business owners who specifically try to establish their businesses in states neighboring New York to avoid the higher rate of sales tax and the complexity of the sales tax forms. I was also privy a case where a jeweler,

with offices in Manhattan, sold and shipped items to customer's homes in other states to avoid the collection and remittance of sales tax on big ticket items.

The Multistate Tax Commission, in 2011, directed its sales and use tax uniformity subcommittee to begin drafting a model nexus statute based on the Amazon case. There is a strong need for federal oversight of state sales and use tax to insure that all states are able to collect their proper tax revenue.

Respectfully submitted,

Sanford Zinman, CPA

On behalf of the National Conference of CPA Practitioners.

Senate Finance Committee Hearing
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
April 25, 2012
Responses to Questions for Mr. Sanford Zinman

Questions from Chairman Baucus

1. Currently, tax laws provide a deduction for state and local taxes. Should these deductions be eliminated or limited as part of tax reform? Why or why not?

   What is the benefit to the federal government for these provisions being a part of the federal tax system?

   Is it fair that only taxpayers who itemize their deductions get the benefit of the deduction for state and local taxes?

Under current law, the potential deduction for state and local income, sales and property taxes are allowed against an individual's income. This was true even in 1913 when "All national, state, county, school and municipal taxes paid within the year" were part of the General Deductions allowed against an individual's income as part of the calculation of taxable income. While there are several explanations written for why these specific deductions were originally allowed, it later became a component of federal government public policy to encourage and support home ownership. The allowance of a deduction for real property tax as well as the deduction of mortgage interest on property theoretically encourages home ownership throughout the country. Often the outlay, net of federal and state tax, is the same as a rent payment. Until recent years, this was the standard for many individuals, and it still allows individuals to afford home ownership.

The standard deduction allows individuals who have few "itemized deductions" to take a greater deduction against their adjusted gross income than they might be able to claim if they were required to deduct only itemized deductions. Renters, for example, would not have deductions for mortgage interest or real property tax. In recent years, the standard deduction has increased. This allows individuals to reduce their taxable income without home ownership.

Currently, in much of the country, those who are able to afford the deduction for state and local property tax (i.e., those who are able to afford a home and obtain a mortgage) are often those individuals whose deductions are limited by factors such as the Alternative Minimum Tax (AMT). In areas of the country where real estate taxes are significant and, consequently, the requisite income to pay these taxes is relatively great, the deduction for these taxes is restricted or eliminated due to the AMT.

The deductions for state and local income and real property taxes are still some of the most significant deductions for taxpayers who do claim itemized deductions even though some of the

benefits are restricted by the AMT. Some 37.2 million taxpayers claimed the deduction for these taxes in 2002, writing off $336.6 billion—or about $9,000 per taxpayer. It represented approximately 37% of itemized deductions and generated slightly more in deductions than itemized deductions for deductible state and local taxes and twice as much in deductions as charitable donations.

Questions from Senator Hatch

1. President Obama has proposed to dramatically reduce the charitable deduction in his latest budget, as well as previous budgets. He does so by proposing to take away up to 29% of itemized deductions for families that are in either of the top two income tax brackets. This will reduce charitable giving. Charity should be the last thing that the President is attacking.

   The President is also going after the ability of families and individuals to exclude interest on tax-exempt bonds from their income. This question is for the whole panel.

   Yes or no—do you agree with me that the President's proposal will increase borrowing costs for state and local governments? Please explain.

As indicated in Mr. Sammartino's testimony, the federal government offers preferential tax treatment for bonds issued by state and local governments to finance certain governmental activities. These bonds are often issued at below market rates because of their preferential tax status. I experienced this first hand as a member of my local school board. We were able to construct a new middle school building only because of the low rate we were able to get on bonds we floated to finance the project. This also translated to lower taxes for the residents of the school district. Across the country this debt is significant and, without the preferential treatment, the needed construction projects would not be possible.

During uncertain economic times there will always be a flight to safety, and states and municipalities with high credit ratings will reap the benefit by having the ability to issue their bonds which will be in demand. This was not always the case. If we look back about 40 years ago, many municipalities were paying premiums on their tax-free bonds and there were limited numbers of people willing to purchase these bonds. The interest rate on and demand for tax-exempt bonds is based on the creditworthiness of the state or municipality and the preferential tax treatment as well as current market conditions.

While municipal bonds, with the benefit of double or triple tax-free status factored, may pay several times a bank short-term CD rate, they often pay the same effective rates as corporate bonds with the same ratings. The current safety and security of municipal bonds as well as the tax-free status of the interest make them a preferable investment to many individual investors.

Questions from Senator Snowe

1. Do you think a national standard to address overlapping and inconsistent requirements is the correct way to balance the rights of states to raise revenue with the rights of taxpayers to tax laws that make compliance possible? There is legislation in the House that would set a 30-day standard for work performed in a state before income taxes would be required. Do you think the House bill achieves that balance?

2. How burdensome would it be for employers to implement time and place of attendance systems for employees who do not otherwise "punch a clock" at their place of work?

Question 1 – States should and do have the ability to set employment standards within their respective jurisdictions. However, our mobile workforce needs to know that the rules controlling their work environment will be consistent from location to location. Additionally, employers should not have to "reinvent the wheel" each time an employee changes their employment location (which may be just across the street) but not their residence. Many small businesses have significant regulatory burdens (and costs associated with these requirements) with regard to compliance with non-resident state and local withholding and employment laws. Employers often, unintentionally, violate the letter of the law when employees cross state borders and earn money in another location. Salaried and hourly employees who work in multi-state environments should report their income in the location where they work and where their income is earned. This is usually not done. Additionally, telecommuting causes additional problems as an employee may be physically in one location but earning their income in another location and being paid according to the employer's office location. The House bill attempts to address some of these issues. While I support the concept of a 30-day window, we must all be aware of potential abuses of this exception. For example, a resident ski instructor from New York could easily travel to and work in Vermont in mid-December through early January and again in late January through mid February, etc. His employer would not have to pay employment or withholding taxes to Vermont although the governmental services (i.e., police and sanitation) would be provided by that state. Obviously any broad scope bill would have areas of omission, and H.R. 1864 does try to ease the employment tax collection and reporting burden on employers.

Question 2 – I do not see any significant burden for an employer to implement a time and place of attendance system for employees. Currently, under tax law, employers and employees must document their job locations for proper reimbursement or income tax deductions. The additional record keeping should not be onerous.

Questions from Senator Enzi

1. I understand that the tax return for the state of New York has a line on it for residents to report the sales and use tax owed. In fact, I am told that it comes with an instruction that says, "Do not leave line 59 blank."

As a practitioner in the state of New York, wouldn't it be easier if the transaction taxes were just collected at the point of sale?

2. You have indicated that complying with an expanded duty to collect would hurt small businesses. However, these are taxes owed by consumers today. As a practitioner, how do you advise your clients to comply with their existing use tax requirements when sales taxes are not collected from purchases made on-line?

3. Last November, a group of bipartisan cosponsors and I introduced the Marketplace Fairness Act. For over a decade, Congress has been debating how to best allow states to collect sales taxes from online retailers in a way that puts Main Street businesses on a level playing field with online retailers. The Marketplace Fairness Act empowers states to make the decision themselves. If they choose to collect already existing sales taxes on all purchases, regardless of whether the sale was online or in store, they can. If they want to keep things the way they are, it's a state's choice.

   Some have commented that legislation like this should be part of tax reform. However, I don't see it that way. I don't see a relationship between this bill and the upcoming negotiations on individual and corporate tax rates and the breadth of the income tax base. Do you agree that this is an issue that is not and should not be confused with tax reform? Do you agree that Congress does not need to wait for tax reform as the context in which to enact something along the lines of the Marketplace Fairness Act?

Question 1 – The short answer is an obvious "yes." It would be easier for both the purchaser and seller if the sales taxes were paid by the purchaser at the time of purchase based on the delivery location. What is more important is that the collection of taxes at the point of sale would result in the proper collection of taxes as well as the ease of collection of information. Most consumers, either individuals or businesses are willing (albeit reluctantly) to pay their fair share of sales taxes as long as the assessment and collection of these taxes is done in a fair and efficient manner. Currently, the burden is on the taxpayer to maintain proper records of the various transactions of the use tax due for sales taxes which were not collected by the seller. This can be a very complicated and time-consuming process and forces an undue burden on an individual or a business. Additionally, the only way to currently enforce the proper collection of these taxes is through an onerous and complete audit of a taxpayer's records, which is economically infeasible. Many individuals in New York just list $0 on line 59 assuming that the probability of an audit is very limited and knowing that the effective statute of limitations runs three years.

Question 2 – Many businesses consider the expanded duty of collecting sales taxes imposed by other jurisdictions in which they do not do business difficult. Often small business owners look to avoid the charging and collection of sales tax by shipping product to another state. The collection duty requires knowledge of specific state and local rules or relatively sophisticated sales tax software. While compliance is not at all impossible, it does make for a cumbersome system. Even much of the sophisticated software has difficulty identifying the nuances of the sales tax rules in different states and localities. However, nuances of the law should not be an

excuse to avoid the law. I believe that the Marketplace Fairness Act goes a long way to overcome many of the obstacles to the states collecting their fair share of sales taxes due.

Question 3 – NCCPAP supports the passage of the Act. The Marketplace Fairness Act is an important step to addressing the sales tax collection process especially in light of the recent Illinois court ruling. I believe that sales tax is a tax which should not be linked with income or employment tax legislation. Consequently any sales tax reform should not be joined with other tax reform associated with the Internal Revenue Code. Additionally, the proper assessment and collection of all sales tax is a significant fiscal issue and should be addressed promptly.

COMMUNICATIONS

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April 20, 2012

Senate Committee on Finance
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Submission of Comments for the Record
United States Senate Committee on Finance
Committee Hearing:

Tax Reform: What It Means for State and Local Tax and Fiscal Policy
Wednesday, April 25, 2012, 10:00 AM
215 Dirksen Senate Office Building

Submitted by:
Carey Verger, Vice President Taxes, Airgas, Inc.

Airgas, Inc. is the largest U.S. distributor of industrial, medical, and specialty gases, and hardgoods such as welding equipment and safety supplies. Airgas is also a major producer of certain industrial gases and a leading distributor of process chemicals, refrigerants, and ammonia products. Radnor, PA-based Airgas is proud to employ more than 14,000 people at over 1,100 locations in the U.S. We support S.1832, the Marketplace Fairness Act as necessary legislation to strengthen our economic policies and achieve basic principles of fairness.

Airgas is a growing company with a physical "brick and mortar" presence across the U.S. (a local presence, nationally). Although we collect sales and use tax from our customers in nearly every tax jurisdiction in America, some of our competitors don't because they sell their products through remote channels - by telephone, mail, and online, into states where they have no physical presence. This is a clear inequity that leads to lost tax revenue to states. It hurts businesses that have invested in communities, giving remote sellers a 5% -10% price advantage.

We believe federal legislation is needed to require equitable sales and use tax collection for all retailers, regardless of location. The Marketplace Fairness Act (S.1832) notes:

> "States should have the ability to enforce their existing sales and use tax laws and to treat similar sales transactions equally, without regard to the manner in which the sale is transacted, and the right to collect--or decide not to collect--taxes that are already owed under State law."

GASES, WELDING & SAFETY PRODUCTS

The Supreme Court, in its 1992 *Quill* decision, ruled that remote sellers, who didn't have a physical presence in the purchaser's state, could not be required to collect state sales tax. The explosion of the Internet over the last 20 years, and improvements in express mail delivery, have made remote selling of commodities nearly as common as local selling. Things have changed quite a bit since the Internet and on-line shopping came onto the scene, and Congress needs to address those changes now.

In response to the Supreme Court's concerns, the Streamlined Sales and Use Tax Agreement (SSUTA) was developed to assist states in administering a simpler and more uniform sales and use tax system. Twenty four states have already enacted legislation to implement the terms of the SSUTA. However, some states appear to be unwilling to implement the terms of SSUTA until federal legislation is enacted to require out-of-state sellers to collect existing sales or use taxes. Smart legislation, such as the Marketplace Fairness Act, will protect small sellers, which are in fact local businesses.

State taxation of *all* remote sales would help level the domestic playing field between large national businesses selling remotely and small local traditional businesses. Providing for state taxation on all sales will end a discriminatory tax practice. The current system centralizes retail sales and results in struggling local economies. Equalization would also increase state government tax revenues - as much as $23 billion in 2012 - a significant factor in a period of tight budgets.

Straightening up this outdated system is a clear, simple step in promoting fairness in our country's fiscal policy. Airgas provides building blocks for the American economy. We supply the construction, health care, energy, transportation, and other industries with critical products and services. We are proud to have a local presence throughout the United States and look forward to continuing our work in promoting local, regional, and national economic development. Accordingly, we encourage Congress to enact legislation for state taxation of remote transactions, like Internet sales, that reflects the realities of modern commerce and helps ensure that all U.S. companies are treated equally, and fairly.

April 25, 2012

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
511 Hart Office Building
Washington, DC 20510

The Honorable Orrin G. Hatch
Ranking Member
Committee on Finance
United States Senate
104 Hart Office Building
Washington, DC 20510

Re: Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Dear Chairman Baucus and Ranking Member Hatch:

Thank you for convening today's hearing on the very important subject of "Tax Reform: What It Means for State and Local Tax and Fiscal Policy." On behalf of Amazon.com, I am pleased to submit the following comments and respectfully ask that this letter and its two attachments be included in the record of the hearing.

Amazon has long supported an even-handed nationwide framework for state sales tax collection, and only Congress may create this framework. To this end, Amazon believes that Congress should authorize the states to require out-of-state sellers to collect the sales tax already owed, and we strongly support enactment of S. 1832, a bipartisan bill already before your Committee.

At the Philadelphia Convention, which the Founders convened principally to consider the challenging issue of trade among the states, Congress was granted exclusive power to regulate interstate commerce. Exactly two centuries later, in 1987, North Dakota challenged this exclusivity and, following five years of litigation, the U.S. Supreme Court held in *Quill v. North Dakota* that requiring out-of-state sellers to collect tax would impose an unconstitutional burden on interstate commerce. The *Quill* court also confirmed that Congress eventually could "disagree with our conclusions" and that this issue is "not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."

Far from an e-commerce "loophole," the constitutional limitation on states' authority to collect sales tax is at the core of our Nation's founding principles. For this reason, Amazon has steadfastly opposed state attempts to require out-of-state sellers to collect absent congressional authorization. We believe that, instead, Congress should enact S. 1832, the Marketplace Fairness Act, to authorize the states to require out-of-state retailers to collect sales tax at the time of purchase and remit those taxes on behalf of

consumers. (*See* attached Letter to Senators Michael Enzi, Richard Durbin, and Lamar Alexander, dated November 9, 2011, referencing the bill that became numbered S. 1832.)

Congress should enact S. 1832 to protect the states' rights, address the states' fiscal needs, and level the playing field for all sellers.

Congress should act to protect the states' right to make their own revenue policy choices. For example, some states have chosen to eschew personal income tax, making them particularly vulnerable to uncollected sales tax. The right of any state to make such policy choice *effective* should be protected by allowing states to ensure that sales and use taxes already owed are collected in a uniform manner, including when sales are made across state lines. And doing so would not violate pledges that are limited to questions of income tax rates and deductions.

The states' financial needs should be addressed. The states face serious budget shortfalls. Adopting sales tax collection reform is a way for Congress to help the states without spending federal funds. S. 1832 would simply allow the states to collect more efficiently the billions of dollars of uncollected sales/use tax revenue already owed.

Fairness among sellers also should be created and maintained. Sellers should compete on a level playing-field. Congress should not exempt too many sellers from interstate collection, for these sellers will obtain a lasting un-level playing field versus Main Street and other retailers. Congress should rectify the current imbalance and avoid a future imbalance.

The facts in the *Quill* decision arose a quarter of a century ago, and the Supreme Court's decision was rendered a year before the World Wide Web was invented. With today's computing and communications technology, widespread collection no longer would be an unconstitutional burden on interstate commerce, and Congress feasibly can authorize the states to require all but the smallest volume sellers to collect. Much attention has been paid to the size of a "small seller exception" threshold in federal legislation – and rightfully so. Such a threshold, which would exempt some sellers from a collection requirement, must be kept low to attain the objectives of protecting states' rights, addressing the states' needs, and creating fairness among sellers.

In this context, several kinds of small volume sellers must be considered. Foremost are the Main Street small business retailers who, unless the small seller exception threshold is kept very low, will forever face an un-level playing field compared to a newly-created exempt class of out-of-state sellers. Next are the online advertising affiliates, tens of thousands of whom have lost jobs or income as the result of ineffective, counterproductive sales tax laws recently enacted in many states. Congressional adoption of reform legislation would immediately restore the lost jobs and income by creating a uniform framework for sales tax collection.

Small volume online sellers have received most of the attention, and not without reason. No one wants these sellers to shoulder alone burdens compared to those faced by the small business retailers who already collect sales tax in our local communities. Yet no one should want these online sellers to have a newly-created un-level playing field advantage over small Main Street businesses, and no one should want government to pick business model winners and losers this way.

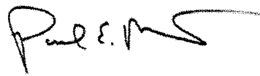
The consequences of the threshold level are significant, because – as described in the attached report on economic research commissioned by Amazon – a surprisingly large fraction of e-commerce is conducted by smaller volume sellers. For example, only one percent of online sellers sell more than $150,000 per year, and only one third of one percent sell more than $500,000. In other words, a $150,000 exception would exempt 99% of online sellers from any collection responsibility on remote sales. *The $500,000 threshold in S. 1832 would exempt 99.7% of online sellers.* (*See* attached report "Online Retail Sellers and Sales Volume Thresholds, by Malowane and Siwek, dated April 2012.)

Fortunately, today's computing and communications technology will readily allow all online sellers to collect and remit tax like Main Street retailers. Large volume online sellers already have and use this technology. Amazon, for example, collects tax on sales to consumers in states where our retail businesses have nexus. And the online arms of large multichannel retailers collect in the states where they have retail stores. Quite obviously, state sales tax can be collected nationwide, and the technology is not limited to large sellers. Rather, service providers also make the technology available to medium and small volume sellers. Thus, collection is either *by* sellers or *for* sellers. There are many service providers already: ADP, Avalara, and FedTax, for example. Ecommerce platforms like Amazon and eBay also can use their sophisticated computing technology to help their third party sellers by collecting sales tax for them, and Amazon is committed to providing such a service.

In conclusion, Congress may, should, and feasibly can attain the objectives of protecting states' rights, addressing the states' needs without federal spending, and leveling the playing field for all sellers. Amazon is grateful for the opportunity to submit these comments, and we look forward to working with you and your colleagues in Congress to pass S. 1832 as soon as possible.

Please let me know if you have any questions.

Sincerely yours,



Paul Misener
Vice President for Global Public Policy

November 9, 2011

The Honorable Michael Enzi
United States Senate
379A Russell Senate Office Building
Washington, DC 20510

The Honorable Richard Durbin
United States Senate
711 Hart Senate Office Building
Washington, DC 20510

The Honorable Lamar Alexander
United States Senate
455 Dirksen Senate Office Building
Washington, DC 20510

Re: Federal Legislation on Interstate Sales Tax Collection

Dear Senators:

Thank you very much for your legislation on interstate sales tax collection.

Amazon strongly supports enactment of your bill and will work with you, your colleagues in Congress, retailers, and the states to get this bi-partisan legislation passed. It's a win-win resolution – and as analysts have noted, Amazon offers customers the best prices with or without sales tax.

If enacted, your bill will allow states to require out of state retailers to collect sales tax at the time of purchase and remit those taxes on behalf of customers, and it will facilitate collection on behalf of third party sellers. Thus, your bill will allow states to obtain additional revenue without new taxes or federal spending and will make it easy for consumers and small retailers to comply with state sales tax laws.

Amazon is grateful for your hard work on this issue, and we look forward to working with you and your colleagues in Congress to pass this legislation.

Please let me know if you have any questions.

Sincerely yours,

Paul Misener
Vice President for Global Public Policy

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Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

For the Hearing

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

Before the

United States Senate Committee on Finance

April 25, 2012

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Statement for the Record on Behalf of the
AMERICAN BANKERS ASSOCIATION
For the Hearing
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
Before the United States Senate Committee on Finance

The American Bankers Association (ABA) is pleased that the Committee is holding this important hearing (Tax Reform: What it Means for State and Local Tax and Fiscal Policy) and appreciates the opportunity to submit a statement for the record. The American Bankers Association represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.

We would like to share with the Committee our concerns about the problems raised by state nexus rules under which states extend their taxing powers to out-of-state businesses. These nexus taxation rules relating to business activity taxes can have a significant impact on banks, particularly community banks that operate near state borders. ABA encourages the Senate to act on legislation that would mirror a bill currently introduced in the House – H.R. 1439, the Business Activity Tax Simplification Act – which we strongly support.

Today, banks of all sizes face difficulties associated with the uncertainty of states' business activity taxes. Over the last few years, states have developed a variety of expansive nexus rules. Some states apply a physical presence rule, some an economic nexus rule, and others a hybrid version that includes both physical presence and economic nexus. The differences in the application of the nexus standard greatly increase compliance and legal expenses for banks – costs that will ultimately be borne by customers and our economy at large.

To address these concerns, ABA strongly supports H.R. 1439, the Business Activity Tax Simplification Act (BATSA), which would modernize existing law to ensure that states and localities can impose business activity taxes only in certain clearly defined situations, such as when an entity has physical presence (i.e., property or employees) and thereby receives related benefits and protections from the jurisdiction. We encourage Congress to enact BATSA in order to provide businesses with more certainty on this issue.

In this statement we detail three key points:

- Inconsistent and unclear taxation standards between states subject businesses to litigation and other onerous business costs, which are especially harmful to small businesses.

- Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs.

- BATSA will help minimize litigation costs and uncertainty for businesses by:

    - Clarifying that entities must have a physical presence in the taxing jurisdiction in order to be subject to state and local taxes; and

    - Providing a clear definition of "physical presence."

I. Inconsistent and unclear taxation standards between states subject businesses to litigation and other onerous business costs, which are especially harmful to small businesses.

An increasing number of states have enacted, or are considering, legislation that would lower the threshold of what constitutes "substantial nexus" for purposes of taxing an out-of-state business' activity within the state. However, there is no uniform definition or application of substantial nexus among the states and no set rules or parameters for determining how a state would apply the nexus standard – it varies from state to state. Therefore, each state applies its own nexus standard to determine when an out-of-state business that has contacts with the state is required to pay income tax. In fact, in some states, the presence of even one customer within the state would establish the state's required nexus for applying its business income tax to an out-of-state business.

This type of application of the nexus standard is devastating for small businesses, especially community banks, because they do not possess the substantial resources required to comply with a proliferation of different state tax laws. There are more than 2,500 banks and savings associations with 25 or fewer employees; 750 of these have 10 or fewer employees. Many of these community banks operate near state borders and, therefore, have contacts with consumers residing in different states. Additionally, many financial institutions now provide services to customers online, which allow people nationwide to take advantage of increased competition and better services to fit their individual needs. Without a uniform standard, these banks find themselves subject to different states' standards, resulting in undue costs and burdens.

II. Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs.

The additional costs resulting from the application of different state taxation standards divert resources businesses could invest in areas such as product innovation, improved customer service, or additional employees. The result would be fewer products offered to consumers at higher prices. Worse yet, without business certainty, some financial service providers may cease doing business in those states where additional tax burdens exist. Therefore, states that aggressively tax out-of-state businesses are creating incentives that may ultimately reduce choices available to consumers in their states. Consumers may experience reduced access to credit and increased credit costs, which is clearly not good for them or the economic health of their communities.

III. BATSA will help minimize litigation costs and uncertainty for businesses by (1) clarifying that entities must have a physical presence in the taxing jurisdiction in order to be subject to state and local taxes, and (2) providing a clear definition of physical presence.

BATSA would remove uncertainty by codifying in federal law that an actual physical presence in a state is required in order for a state to impose a tax on an out-of-state business. It also would include a bright-line test that would establish a minimal amount of activity a business must perform in a state before it is subject to income taxes and additional paperwork. Finally, this bill

would help limit businesses' exposure to unanticipated taxes, thus reducing compliance and legal costs associated with frivolous nexus claims.

Conclusion

As you continue your efforts on tax reform in the Senate, ABA strongly encourages legislation that would provide a uniform definition for the nexus standard to be employed by states in establishing whether an out-of-state business should be subject to tax for activities conducted within the state. BATSA provides such a mechanism and we urge consideration of a bill in the Senate that mirrors these provisions. Such a bill would greatly help streamline the out-of-state business activity tax within states and limit businesses' exposure to burdensome and costly taxes.

Oren Teicher, CEO
American Booksellers Association
200 White Plains Road
Tarrytown, NY 10591

Written Testimony, submitted for the
Senate Committee on Finance hearing:
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
April 25, 2012

Dear Chairman Baucus, Ranking Member Hatch, and Distinguished Members of the Committee:

The American Booksellers Association is a national, not-for-profit trade association whose mission is to protect and promote the interests of its members: independently owned bookstores, large and small, that have storefront locations and e-commerce websites based in towns and cities nationwide.

On behalf of our independent bookstore members, we wish to express our support for the bipartisan Marketplace Fairness Act (S.1832), which would give states the right to decide to collect -- *or not to collect* – sales and use taxes for online sales from out-of-state businesses. Importantly, this bill would not impose a new tax, as these are taxes that are already owed.

For more than a decade, our members have worked at an unfair competitive disadvantage compared to remote, online retailers that have nexus in states but have skirted their obligation to collect and remit sales tax. Many of these remote retailers have a physical presence via warehouses, offices, distribution facilities, or a broad network of online affiliates (that act as a virtual sales force for online sellers).

While our members are more than capable of competing with their online competitors in an open and fair marketplace, it is very difficult for any business owner, no matter how savvy, to compete at a disadvantage equal to their community's sales tax rate.

Something has to be done, sooner rather than later. As online commerce has grown, each year more and more consumers eschew shopping on Main Street in the mistaken belief that products purchased online are "duty free." This is not the case, as consumers owe a use tax when they purchase an item online and no sales tax is charged. That, however, is not a well-known law, and, more importantly, use tax laws are almost impossible to enforce.

The resulting loss of sales tax revenue and its impact on Main Street's ability to compete has forced many of our member bookstore owners to reduce staff, staff hours, or forced them to forgo the hiring of new employees. A level playing field and a free market where the state government isn't unintentionally subsidizing the competitors of its own in-state businesses would go a long way toward increasing revenues and creating jobs nationwide.

The Marketplace Fairness Act would solve this inequity by authorizing states *that choose to do so* to require remote retailers to collect and remit sales tax. This is crucial. Some states have already clarified their sales tax laws to account for the clear fact that online affiliates are modern-day sales agents, but even so, many states have been reluctant to follow suit for fear they will bring about a lawsuit from a large, corporate online retailer that wishes to maintain its inequitable competitive edge over Main Street -- or, in some cases, because of a different interpretation of the 1992 *Quill vs. North Dakota* Supreme Court decision.

S. 1832 would put the sales tax collection issue back into the hands of the states, where it belongs.

Thank you for your consideration in this important matter.

Sincerely,

Oren Teicher, CEO
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Tallahassee, FL

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Statement for the Record
of the
American Federation of State, County and Municipal Employees (AFSCME)

For the Hearing on
Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Before the
Committee on Finance
U.S. Senate
April 25, 2012

American Federation of State, County and Municipal Employees, AFL-CIO
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Statement for the Record
of the
American Federation of State, County and Municipal Employees (AFSCME)
For the Hearing on
Tax Reform: What It Means for State and Local Tax and Fiscal Policy
Before the
Committee on Finance
U.S. Senate
April 25, 2012

This statement for the record of the hearing "Tax Reform: What It Means for State and Local Tax and Fiscal Policy" is submitted on behalf of the 1.6 million members of the American Federation of State, County and Municipal Employees (AFSCME). AFSCME members work for all levels and all types of government, including states, cities, counties, school districts, and other jurisdictions. We advocate for excellence in public services, fairness in the workplace, and prosperity and opportunity for all working families. AFSCME members are a diverse group of people sharing a common commitment to public service, and a fundamental part of our mission is to advocate for the vital public services and infrastructure that keep our families safe and strengthen our communities.

How federal tax reform is structured will have a significant impact on state and local governments which are a vital part of our federal system. AFSCME supports progressive federal tax policies that help ensure state and local governments can invest adequately in public education, health care, job creation, infrastructure, and the social safety net. We oppose regressive tax policies and those that undermine state and local government's ability to meet the needs of their residents.

In summary, AFSCME supports the bipartisan Enzi-Durbin-Alexander "Marketplace Fairness Act," S. 1832. As a general rule, AFSCME opposes preempting state government and local government tax authority. We also support the existing federal personal income tax deductions for state and local government taxes, the existing federal tax exclusion for interest income from state and local government public purpose bonds, and reinstating Build America Bonds with helpful changes. Further, AFSCME recommends considering alternatives, including tax credits, to certain business deductions, where they currently result in reduced state tax revenues.

I. State and Local Government Taxing Authority

Marketplace Fairness Act

AFSCME strongly supports the bipartisan "Marketplace Fairness Act" (S. 1832), introduced by Senators Enzi (R-WY), Durbin (D-IL) and Alexander (R-TN). This bill is needed because it empowers state and local governments to collect sales or "use" tax already owed by buyers on their remote purchases of goods and services via the internet, phone and mail. It would close an unfair loophole that allows e-tailers and other remote sellers to avoid collecting sales taxes, thereby unfairly disadvantaging brick and mortar businesses. S. 1832 would help enable these Main Street brick and mortar retailers to compete fairly on a level field against out-of-state

e-retailers. It is important to close this loophole because it influences consumer behavior and purchases, and it diverts sizable revenues from states and localities.

In 2012, experts estimate the cumulative nationwide total of uncollected state and local government use taxes is $23 billion. While revenues of this magnitude are always important, given the recent and ongoing struggles of America's economy and the resulting state and local government budget shortfalls, these jurisdictions need these revenues to adequately invest in job creation, infrastructure, health care, public education, and other vital public services. S. 1832 would simultaneously reduce pressure on states and localities to increase taxes and/or reduce services; and eliminate the unfair advantage of internet-based businesses over bricks and mortar stores.

It is important to highlight that S. 1832 would not enact any new taxes. S. 1832 merely authorizes states and localities to require sellers to collect already authorized but currently uncollected taxes. The 45 states (and the District of Columbia) currently imposing a sales tax, also impose a parallel use tax, which requires that buyers who do not pay sale taxes on their remote purchases do pay an equivalent use tax on these purchases. We also note S. 1832 has no cost to the federal government. It is not an unfunded mandate.

A broad and ideologically diverse coalition supports S. 1832. AFSCME joins in support of S. 1832 with other labor unions representing the public sector; state and local government interest groups; and hundreds of various businesses, including small mom and pop shops, large corporations, and trade associations representing diverse interests. For example, a joint labor union sign-on letter in support of the "Marketplace Fairness Act" (S. 1832) is attached at the end of this testimony. Moreover, S. 1832 has strong bipartisan Senate support urging enactment.

State or Local Government Tax Authority Preemption

AFSCME strongly opposes restricting or preempting state government or local government tax authority. Proposed policies in support of this objective would establish harmful, inappropriate, and costly precedents of federal preemption over state and local fiscal decisions. Congress should not prevent a state or local government from deciding its own needed combination of taxes, fees or revenues. Currently, each state and locality decides its own tax base, rates and revenue goals. For example, each jurisdiction has the autonomy to decide its own unique combination of taxable goods and services, set its own varied tax rates, address the needs of its local economy and meet its revenue needs. We believe this should remain an inherent function of state and local governments.

During the current and prior congressional sessions, many special interest preemption bills were introduced and debated targeting various specific products, industries and taxes. However, they all share one major theme in common. Under the pretense of "tax simplification" or "tax fairness," these preemption proposals are designed to reduce taxes, mostly on businesses that are otherwise due to states and localities, and thereby reduce the revenues needed to adequately invest in public education, health care, job creation, infrastructure and the social safety net. For these reasons, AFSCME is opposed to proposals which restrict or preempt state or local government tax authority, including:

- The Digital Goods and Services Tax Fairness Act (S. 971 & H.R. 1860);
- The Wireless Tax Fairness Act (S. 543 & H.R. 1002);
- S. 1934, which contains a permanent moratorium on internet access taxes and discriminatory taxes on electronic commerce, and prohibits state taxation of certain travel services;
- The End Discriminatory State Taxes for Automobile Renters Act (H.R. 2469);
- The Mobile Workforce State Income Tax Simplification Act (H.R. 1864); and
- The Business Activity Tax Simplification Act from previous Congresses.

II. Federal Income Tax Deductions and Exclusions

Federal Personal Income Tax Deductions

AFSCME strongly supports retaining the existing federal personal income tax deduction for state and local government income tax and property tax. AFSCME also supports the federal deduction for state and local government retail sales taxes, which expired Dec. 31, 2011. The deduction for state and local taxes has been a vital part of the federal income tax system since it began. It was one of only two deductions specifically provided for in the Income Tax Act of 1861. These vital deductions recognize the principles of federalism, avoid double taxation, and ease state and local government financing for needed public services and infrastructure. Moreover, they are essential to maintaining and enhancing the progressivity and adequacy of state and local tax systems.

Federal Tax Exclusions for Interest Income and Build America Bonds

AFSCME strongly supports the existing federal tax exclusions for interest income from state and local government public purpose bonds. This exclusion helps state and local governments reduce their financing costs for modernizing infrastructure, including America's public schools, mass transit and transportation network, and systems for delivering safe drinking water, electricity and other daily necessities.

We also have been a strong supporter of Build America Bonds. Given its recent expiration, AFSCME supports a permanent program for Build America Bonds. This could include proposals for a 28% federal subsidy level, which is intended to be revenue neutral compared to estimated future federal tax expenditures for tax-exempt bonds, and/or enhancing eligible uses to include short-term government working capital financings of governmental operating expenses.

Tax Credits for Certain Business Deductions

Almost every state links its tax code to the federal internal revenue code for both personal income tax and corporate income tax purposes. Thus, some federal tax provisions, notably domestic production deduction and bonus depreciation, result in significantly reduced state tax revenues. To the extent these provisions remain in the code, it would be useful to consider other options for implementing these provisions, to which states are not linked, such as tax credits.

III. Conclusion

Federal tax policy has a direct and significant impact on state and local government finances. It is therefore important that careful consideration be given to the consequences, intended or not, of changes in federal law which affect the ability of states, cities, counties and other jurisdictions to provide vital public services for the common good. In considering various tax reform proposals, careful consideration should be given to preserving state and local tax authority and fostering an environment of fairness, growth and stability.

April 24, 2012

Unions strongly support bipartisan "Marketplace Fairness Act" (S. 1832), which empowers state and local governments to collect sales and use tax from remote sellers

Dear Senator:

Our undersigned labor unions strongly support the bipartisan Enzi-Durbin-Alexander "Marketplace Fairness Act" (S. 1832). It grants states, which streamline their tax systems to facilitate certain business transactions, the authority needed to collect the sales and use taxes they are owed. We urge you to support S. 1832 and vote for it when the opportunity arises.

Our unions have long supported constructive Congressional proposals that enable state and local governments to collect sales and use tax from remote and online sellers of goods and services. We advocate for closing tax loopholes that allow sellers to avoid collecting sales tax on hundreds of millions of remote purchases made via internet, telephone, and mail. While the loopholes always cause problems, they are very troubling now because states and localities suffer from years of broadly reduced revenues. In addition, out of state and online sales are skyrocketing along with uncollected sales and use taxes. Also, these loopholes inflict increasingly unfair competitive disadvantages on Main Street and mom-and-pop retailers. According to University of Tennessee economics professor Dr. William Fox, uncollected use tax from all remote sales in 2012 will cost state and local governments a cumulative $23 billion.

Now is the time to enact S. 1832. First, Congress has clear constitutional authority to act to regulate interstate commerce of online and remote sales and S. 1832 has bipartisan support. Second, state and local governments are urging Congress to act and strongly support S. 1832. Their ongoing participation in developing the Streamlined Sales and Use Tax Agreement demonstrates effective and efficient solutions exist. Third, both large and small businesses support S. 1832 because it levels the playing field for businesses and streamlines sales tax systems. Fourth, the claim that it is too burdensome to require small business remote sellers to collect sales and use tax is no longer convincing. Most experts now agree that accurate and affordable sales tax collection software exists and enables relatively effortless collection of sales taxes. S. 1832 also protects sellers with a hold harmless for calculating and collecting sales taxes with data and certified technology provided by participating states.

"Marketplace Fairness Act" would not enact new taxes. The affected taxes already exist under current law in all 45 states (and the District of Columbia), which impose a sales and use tax. Unfortunately, millions of U.S. consumers either unknowingly or purposely do not pay existing use taxes on their remote and online purchases. S. 1832 merely provides states the authority and ability to collect these existing uncollected taxes. We also note that S. 1832 has no cost to the federal government.

Given America's ongoing economic challenges, we think Congress should grant state and local governments the legal authority to collect taxes already owed on remote and online sales, which would simultaneously ensure businesses face a level playing field competing for consumers.

We urge you to support and vote for the "Marketplace Fairness Act" (S. 1832).

Sincerely,

American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)
American Federation of State, County and Municipal Employees (AFSCME)
American Federation of Teachers (AFT)
Department for Professional Employees, AFL-CIO
International Association of Fire Fighters (IAFF)
International Federation of Professional and Technical Engineers (IFPTE)
National Education Association (NEA)
Service Employees International Union (SEIU)
The International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW)

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**Statement
Of the
AMERICAN PUBLIC POWER ASSOCIATION
Submitted to the
SENATE FINANCE COMMITTEE
For the hearing on
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"**

Submitted May 9, 2012

The American Public Power Association (APPA) appreciates the opportunity to submit this statement regarding tax reform and what it means for state and local tax and fiscal policy. While a number of issues relating to tax reform will have a direct effect on our members, this statement will focus on tax-exempt financing through tax-exempt bonds.

By way of background, APPA is the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit utilities throughout the United States (all but Hawaii). Collectively, public power utilities deliver electricity to one of every seven electricity consumers (approximately 46 million people), serving some of the nation's largest cities. However, the vast majority of APPA's members serve communities with populations of 10,000 people or less.

Overall, public power systems primary purpose is to provide reliable, efficient service to local customers at the lowest possible cost, consistent with good environmental stewardship. Public power systems are locally created governmental institutions that address a basic community need: they operate on a not-for-profit basis to provide an essential public service, reliably and efficiently, at a reasonable price.

The majority of APPA members finance electric infrastructure through the issuance of debt to the domestic capital markets. Federal tax exemption for interest paid on such debt permits municipal issuers to sell public purpose debt at lower interest rates when compared to debt the interest on which is subject to federal income tax. Most of the overall infrastructure in the United States is financed through the issuance of tax-exempt bonds.

It is a long-standing principle that the federal government should not tax interest on municipal bonds. This reflects the basic "federalism" principle that one level of government should not tax

another. This principle applies–with some exceptions–to almost all forms of government financing. So, just as state and local governments do not assess property taxes on federal property within their jurisdictions and do not tax interest on Treasury bills, notes or bonds, so the federal government should not tax municipal bond interest.

This principle was at the core of the 1895 Supreme Court decision that, as a Constitutional matter, the federal government could not impose such a tax.[1] The Revenue Act of 1913 codified this exemption, restated in Section 103(a) of the Internal Revenue Code of 1954 and reaffirmed in the Tax Reform Act of 1986. While the latter greatly reduced private activities that may be financed with tax-exempt bond proceeds, it did not fundamentally alter the exemption for bond financing of public activities as is being considered.

Even after the Supreme Court found that the federal government could regulate municipal bonds in 1988[2]—a decision taken as opening the door to begin taxing bond interest—Congress has continued to honor the principle that the federal government should not tax state and local bonds.

Of late, however, there has been a disturbing willingness among some policymakers to consider abandoning this principle.[3] As an obvious result, confirmed by recent analysis, such a change would increase the cost of state and local borrowing, in turn leading to an immediate reduction in investments in infrastructure. This is bad economic policy at two levels: it would result in fewer jobs for those who would build, repair, and improve this infrastructure; and it would hurt the businesses who rely on this infrastructure to be productive.

It is also an unnecessary step. While some rationalize the decision to propose a tax on state and local bonds with the argument that "everything must be on the table," some major tax reform proposals retain the tax exemption for such bonds.[4]

As a result, APPA believes that tax-exempt financing should be preserved and enhanced—not further limited. This includes reversing the limits put on tax-exempt bonds in the Tax Reform Act of 1986. Tax-exempt financing is critical for maintaining infrastructure, updating electric utility services, providing electricity at reasonable costs for ratepayers, and creating jobs. In sum, APPA opposes any efforts through tax reform, or other legislation, to undermine or limit this important financing tool.

Thank you again for this opportunity to discuss the effect of federal tax reform on state and local tax and fiscal policy.

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[1] Pollock v Farmers' Loan & Trust Company, 157 US 429 (1895).
[2] South Carolina v. Baker 485 US 505 (1988).
[3] National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (Draft Report) 31 Dec. 2010 (proposing the taxation of interest on new issues); Bipartisan Tax Fairness and Simplification Act of 2011, S. 727, § 111, 112th Cong., 1st Sess. (2011) (proposing the conversion of the exclusion of interest into a capped tax credit); U.S. Dept. of Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, 73, (Feb. 2012) (limiting the value of the exclusion of bond interest to 28 percent).
[4] Bipartisan Policy Center, "Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System" 128 (Dec. 28, 2010).

Prepared Statement of

American Trucking Associations

Before the

Committee on Finance

United States Senate

April 25, 2012

Hearing on State & Local Tax & Fiscal Policy

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

The health of this Nation's economy depends critically on interstate commerce, and interstate commerce in turn depends very heavily on efficient freight transportation. Most of that freight is carried by truck – some 67% by tonnage and some 81% as measured by transportation receipts. The interstate motor carrier industry is correspondingly large, comprising several hundred thousand for-hire trucking companies. Although a few carriers are large, the overwhelming majority of trucking companies are, by any definition, small businesses. The average trucking company operates a fleet of only six trucks, and there are many thousands of operations with only a single vehicle.[1] In many respects, these small businesses resemble their counterparts in other industries, except that even the smallest motor carriers may travel into dozens of states in the regular course of their business.

Our industry faces a serious threat of disproportionate compliance costs related to state business taxation, from states in which trucking companies do little or no business and with which they have few if any of the connections that are commonly considered to establish tax nexus. The American Trucking Associations appreciates this opportunity to join with other industries to support the call for federal relief from overreaching and inequitable state taxation of interstate commerce.[2] We emphasize that our industry's primary concern in this area is compliance costs rather than the amount of taxes involved. The relief we request should affect aggregate state revenues little if at all. We urge Congress to enact such business tax relief promptly.

<u>Background</u>

Until 1980, interstate motor carriers were subject to strict federal regulation in an economic sense. Prior to deregulation, individual trucking companies did not typically travel in more than a few states and therefore were not exposed to taxation in many states. The great expansion in the number of trucking companies and in the scope of their operations in a largely deregulated economy has changed that. And with deregulation, states began to tap what they saw as a new source of revenue. The fact that trucking companies might be involved in critical areas of interstate commerce seems to have made them more rather than less attractive objects for taxation for states and localities, since, in any given place, most of the trucks passing through do not represent local residents but businesses from outside the state.

[1] Some 90% of motor carriers operate fewer than six trucks; only some 3% operate more than twenty. American Trucking Assns., *2012 American Trucking Trends*, ATA: Arlington, VA, 2012, pp. iv-vi.
[2] ATA is the national trade association of the American trucking industry. It is a united federation of motor carriers, state trucking associations, and national trucking conferences created to promote and protect the interests of the motor carrier industry. ATA's membership includes nearly 2,000 trucking companies and suppliers of motor carrier equipment and services. Directly and indirectly through our affiliated organizations, ATA encompasses over 37,000 companies and every type and class of motor carrier operation.

Prior Congressional Action

Time and again since 1980, Congress has had to step in to protect the motor carrier industry from the effects of state and local taxation, to restrict the taxing authority of these jurisdictions and the manner in which they may administer otherwise valid taxes. Some years ago, for example, a number of states began to assess personal income taxes against interstate truck *drivers* who merely drove through in the course of their employment. Congress responded to this intolerable situation by prohibiting any state but the state of residence from taxing an interstate transportation worker, and from requiring transportation company employers from withholding wages except for the state of residence.[3] Again, following a U.S. Supreme Court decision on a state tax issue that could drastically have affected interstate bus operators, Congress stepped in to give this segment of the motor carrier industry the relief it needed.[4] And in the Motor Carrier Act of 1980 itself, Congress provided the industry protection against discriminatory state and local property taxes and access to federal district courts to invoke that protection.[5]

Because of deregulation and the competition it has so successfully fostered, trucking is today a low-margin industry. Deregulation of our industry has saved the overall American economy billions in reduced transportation costs, but truck rates remain much lower in real terms than they were in 1980.[6] In a typical year, the average for-hire trucking operation may clear a 2% to 3% profit - very roughly, *3 to 6 cents per mile* traveled by a truck. In a bad year, the average industry profit may sink close to zero.[7] Compared to many other industries, motor carriers commonly have little in the way of net income for states to subject to tax.

The recent recession was very hard on the trucking industry, as it was on so many other businesses. The deregulated industry had never faced times like these. Motor carriers that have survived the last few years now face both very high fuel prices and unprecedentedly high prices for the replacement of their equipment. Those higher truck prices are driven in large part by the cost of environmental regulation, and smaller trucking operations are in many instances hard-pressed to find financing for the equipment they need to buy. Unwarrantedly high state and local tax compliance costs are, for a growing number of our members, another source of hardship.

Under economic regulation, except for the largest operations, motor carriers fulfilled their state business tax obligations at home. To a great extent, this has remained the case: small trucking companies, like small businesses in other industries, file corporate tax reports in their state of domicile and in perhaps one or two others where a significant

[3] *See*, 49 U.S.C. 14503.
[4] *See*, 49 U.S.C. 14505.
[5] Congress has granted the railroad industry much more comprehensive protection in this respect, however; compare 49 U.S. 14502(b) with 49 U.S.C. 11501(b).
[6] American Trucking Assns., *2012 American Trucking Trends*, *op. cit.*, p. 18.
[7] Statistics from 1993 through 2002. American Trucking Assns., *2004 American Trucking Trends*, ATA: Alexandria, VA, p. 15. The U.S. DOT has yet to release data for more recent years.

proportion of their business may occur.[8] Indeed, the typical smaller trucking operation has but one place of business – in its home state – and has no property or payroll in any other jurisdiction.[9]

Held for Ransom

Imagine now if you will the situation of a small trucking company, one that might be based in any state and operates only a few trucks. In the course of its business, it gets a call to pick up or to deliver a load in New Jersey, a state it may enter only occasionally. In New Jersey, perhaps at a rest stop or a shipper or consignee's loading dock, an agent of the New Jersey Division of Taxation approaches the truck, identifies himself to the driver, states that the company hasn't registered for the state's corporate tax, and asks the driver how long the company has been picking up or delivering loads in New Jersey. The driver is unlikely to know, of course, but will probably venture some number of years. The state multiplies the number given by $1,100, and the resulting sum serves as a "jeopardy assessment" of corporate tax – in practical effect the ransom for the truck, the driver, and its cargo. The truck and cargo is impounded, the driver is told to contact the company and that the truck will be released only when the money is wired to the state. If the driver protests at the outrage, he may be taken to jail. There is evidence that New Jersey has assessed some 40,000 interstate motor carriers in this manner over the last five to ten years, most of them small businesses.[10] New Jersey does accord a carrier the option of appealing an assessment – once it has been paid – but the process is long, laborious, expensive, and uncertain.

Other State Campaigns

New Jersey is – so far – the only state that has attacked interstate commerce by truck so aggressively. Periodically, however, and typically in difficult economic times like the present, one or more states mount a general campaign to force smaller trucking companies located outside their borders but traveling on their roads to pay their business taxes. Such a campaign typically starts with a widespread mailing of a "nexus questionnaire" to hundreds or thousands of motor carriers that have paid operating taxes

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[8] All interstate trucking operations, large and small, pay vehicle registration fees and motor fuel taxes for the use of the roads to each state in which they travel. Carriers fulfill these obligations to pay taxes through two organizations – the International Registration Plan and the International Fuel Tax Agreement – which, under Congressional mandate (*see*, 49 U.S.C. 31701, *ff.*), ensure that all states administer these tax programs by means of a uniform structure that guarantees to all states the revenues due them and minimizes administrative costs for state and motor carrier alike. These operating taxes are not at issue here.

[9] Larger companies, of course, with facilities in multiple states, are obligated to file returns in those states as well as where their home offices are located.

[10] Note too that owner-operators that have incorporated, and many have, are also subject to the New Jersey tax, even though they may never operate in the state under their own interstate authority, but always while leased to another carrier. Sometimes, therefore, the presence of a single truck, making a single delivery of freight, is nexus – as far as New Jersey is concerned, that is – for *two* entities. In hard economic times, a jeopardy tax assessment such as those New Jersey has been in the habit of levying on the industry could easily be the last straw for a company attempting to stave off bankruptcy.

to the state.[11] Companies that answer the questionnaire and return it – and those that do not return it receive increasingly threatening communications from the state until they do – typically then receive a further letter from the state, advising them that the state has determined that they have nexus there and enclosing a bill, typically for several years (occasionally even decades) of back taxes, plus penalty and interest.

Particularly for smaller motor carriers, this is a cruel absurdity. Typically, the state that seeks to force interstate motor carriers to pay its business taxes not only assesses for years of back taxes, but also either imposes a minimum corporate tax or taxes gross rather than net receipts.[12] Through the use of these gimmicks, a state will have magnified the claimed liability out of all proportion either to the carrier's travel in the state or to its net income.

A large, unanticipated assessment for back taxes frequently represents a disaster for a small (or even a larger) motor carrier. For the more distant back years, the carrier will also be precluded by the statute of limitations from amending the returns it filed with its home state and claiming a credit. Last – and definitely not least – are the accountant's fees the carrier must pay to have the newly required return prepared. These can run upwards of $1,500 for even a single, relatively simple corporate tax report. And this is an expense the carrier can look forward to bearing in each year into the future, for once it starts filing an annual tax return with a state it cannot easily stop doing so.

It is these compliance costs – the accountant's costs, and the sheer labor, time, and trouble involved in complying with numerous varying state requirements – of which our industry most complains. Trucking companies are not trying to avoid their tax obligations; they understand that the government services they really avail themselves of must be paid for. But they do object to paying exorbitant costs for complying with the requirements of states where they have no establishment, where they have little business, and where the nexus rules, where they published at all, are extremely vague as regards interstate trucking operations.

State Nexus Standards

What do states commonly assert as tax nexus for an interstate motor carrier? This is often unclear; state tax statutes and regulations often have nothing specific to motor carrier nexus, and provisions adequate for less mobile industries can be perplexing for administrator and carrier alike when applied to trucking. Moreover, while it is undoubtedly the case that a state may under the U.S. Constitution levy a tax on an

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[11] When the Pennsylvania Department of Revenue began its "nexus campaign" against the industry about 1993, it mailed out threatening notices and assessments to some 30,000 interstate trucking companies.
[12] California, Massachusetts, New Jersey, New York, and Pennsylvania have all aggressively sought to tax interstate motor carriers while they imposed minimum taxes of several hundred to well over $1,000 per year. Michigan and Pennsylvania have sought to impose taxes based at least in part on gross receipts on the industry. Other states that regularly seek to impose their business taxes on interstate motor carriers with only slight contacts with the state include Illinois, Nebraska, Ohio, Virginia, and Wisconsin.

interstate motor carrier,[13] the U.S. Supreme Court has left this area of the law in obscurity. A state may make a mere assertion of nexus rather than define it exactly. Until recently, no state has sought to collect tax from a motor carrier that merely travels on its roads and has no business at all in the state, but now at least a couple of states seem prepared to try to collect money on even that slim basis.[14]

This uncertainty in the law leaves motor carriers in a quandary, not knowing whether to file in a given state or not. Many motor carriers, typically on the advice of their accountants, file in many more states than may be warranted, and spend thousands of dollars annually in accountants' fees to pay perhaps hundreds of dollars or less in state taxes.[15] Others, in the absence of any indication from a state that out-of-state carriers need to file there, forego filing until suddenly the state changes its position and sends out bills for three, five, seven, or more years of back taxes to thousands of interstate carriers. Motor carriers commonly find it extremely difficult to pass on these compliance costs to their customers.

State Retaliation

The year 2009 saw something new in this difficult area – an instance of one state threatening to retaliate against another because of the latter's aggressive pursuit of business taxes motor carriers based in the former. Colorado Joint Resolution HJR09-1024, adopted May 6, 2009, and attached to this testimony, first recites the elements of the problem we are addressing here, and then encourages the Colorado Department of Revenue to increase its enforcement of Colorado business taxes against carriers based in states that have "unreasonably" burdened Colorado's. In somewhat similar fashion, South Dakota Senate Concurrent Resolution 7, adopted March 9, 2009, and also attached to this testimony, calls on the state of Nebraska to "provide tax relief and amnesty" to trucking companies based in South Dakota. The situations these resolutions seek to address are serious, but it may be evident that state efforts of this sort could easily make things worse rather than better for interstate motor carriers. A federal solution is needed. The current economic times only make this more urgent.

A Federal Solution

For the reasons we have outlined, interstate motor carriers are now approaching Congress for relief from the efforts of states to impose their taxes on interstate trucking companies that have only very tenuous contacts with those states. Public Law 86-272 is of very limited – if indeed any – assistance to our industry, and the provisions of that law, which

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[13] In fact, the leading case in this area, *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), involved state taxation of a motor carrier.

[14] Nebraska and New Mexico have recently asserted nexus for motor carriers on the basis solely of such "pass-through" miles, no other contact with the state being, in their view, legally necessary. Carriers that ignore or question Nebraska's collection efforts may have liens filed against their equipment.

[15] Filing in many states has another danger for interstate motor carriers: overlapping state apportionment formulas can capture more than all of a carrier's net income for state taxation. *See*, for example, *Consolidated Freightways Corp. of Delaware v. Wisconsin Dept. of Revenue*, 477 N.W.2d 44 (Wisc., 1991).

was both necessary and appropriate for its time, urgently need updating to reflect the Nation's deregulated, more mobile, more service-oriented economy. Trucking companies – and interstate commerce, to which trucking is so critical – need protection from taxation by a state when they do not have a significant physical or legal establishment within its borders. Nor, because of our industry's operations, would a solution such as that offered by the Business Activities Tax Simplification Act, H.R. 1439, provide much relief to motor carriers. The provisions of that legislation would leave the nexus rules for motor carriers largely undefined.

We recommend that Congress pass legislation that would permit a state to impose a business tax on a for-hire interstate motor carrier only if that carrier has real property or has obtained intrastate operating authority in that state, or is incorporated or has its principal place of business in that state. This will leave the vast majority of motor carriers to report and pay business taxes only at home, and would leave the aggregate state taxes collected from the motor carrier industry as a whole substantially unchanged. In many respects, our proposal closely resembles the relief we cited earlier that Congress enacted for truck drivers, when those employees were being harassed by states they merely drove through in furtherance of interstate commerce. Local government impositions on motor carriers can also be a significant burden. Congress should extend whatever relief it may enact with respect to state motor carrier taxation to cover local taxes as well.

We anticipate that a bill incorporating our solution to this pressing problem will shortly be introduced. We recommend it to the Committee's attention, and urge Congress to enact such relief for motor carriers promptly.

We appreciate very much this opportunity to testify before the Committee.

Robert C. Pitcher
Vice President, State Laws
American Trucking Associations

SENATE CONCURRENT RESOLUTION NO. 7

A CONCURRENT RESOLUTION, Requesting the State of Nebraska to provide tax relief and amnesty for certain South Dakota trucking companies.

WHEREAS, the State of Nebraska has recently notified many South Dakota trucking companies that they are required to file Nebraska state income tax returns; and

WHEREAS, the State of Nebraska has a state income tax which applies to the trucking industry and is administered by special trucking rules. The Department of Revenue from the State of Nebraska has contacted many South Dakota trucking companies to ascertain their potential income tax obligation to the State of Nebraska. These companies were unaware of their income tax obligation to the State of Nebraska; and

WHEREAS, the actual taxable revenue is apportioned to Nebraska for those loads that are loaded and unloaded in Nebraska. Otherwise, apportionment is based on all the miles traveled in Nebraska divided by the overall miles traveled by the trucking company; and

WHEREAS, the South Dakota trucking companies did not anticipate that they could incur a Nebraska income tax obligation for miles traveled in Nebraska when the load was either loaded or unloaded within the boundaries of another state or country; and

WHEREAS, economic times have been extremely difficult for many industries and individuals as well as governmental units, especially state governments. It is understandable in these difficult times, that states look for every source of revenue; and

WHEREAS, the State of Nebraska and the State of South Dakota have each agreed to a tax amnesty policy regarding other forms of taxation. For example, the Streamlined Sales Tax Project amnesty program is an attempt to have potential tax payers report and pay their current and future tax obligations in a timely manner without worry of substantial penalty; and

WHEREAS, South Dakota trucking companies are now better informed of their income tax obligation to the State of Nebraska and the rules that administer and apply that income tax:

NOW, THEREFORE, BE IT RESOLVED, by the Senate of the Eighty-fourth Legislature of the State of South Dakota, the House of Representatives concurring therein, that the South Dakota Legislature requests the Nebraska Legislature to forgive all or part of the income tax due for past

years on South Dakota trucking companies and to apply this tax on current and future income. Favorable resolution of this matter by the Nebraska Legislature will provide relief to an industry that also faces financial struggles; and

BE IT FURTHER RESOLVED, that the South Dakota Legislature requests the Nebraska Legislature to develop an amnesty program for out-of-state trucking companies. The amnesty program will encourage the trucking companies to file income tax returns and pay their tax obligations in a timely manner without fear of severe penalties and interest; and

BE IT FURTHER RESOLVED, that the South Dakota Legislature expresses its appreciation for the Nebraska Legislature's consideration of this matter.

Adopted by the Senate,	March 5, 2009
Concurred in by the House of Representatives,	March 9, 2009

Dennis Daugaard President of the Senate	Trudy Evenstad Secretary of the Senate
Timothy A. Rave Speaker of the House	Karen Gerdes Chief Clerk of the House

CONCERNING ACTION OF THE STATE OF NEBRASKA IN SUBJECTING INTERSTATE MOTOR CARRIERS BASED IN COLORADO TO UNWARRANTED TAXATION.

WHEREAS, Colorado's interstate motor carrier industry is an essential component of this state's economy; and

WHEREAS, Colorado's interstate motor carrier industry is made up overwhelmingly of small businesses; and

WHEREAS, the state of Nebraska has for the past several years been seeking to subject interstate motor carriers based in Colorado to corporate income taxation in that state, although such carriers have no real property, assets, or employees in Nebraska; and

WHEREAS, although the imposition of such taxes by the state of Nebraska involves a recent change in position by the revenue agency of that state, Nebraska has sought many years of back taxes from interstate motor carriers based in Colorado; and

WHEREAS, the burden of such unwarranted taxation and the heavy associated compliance costs is particularly significant for Colorado motor carriers in this time of economic distress; and

WHEREAS, the Colorado Department of Revenue has never sought to impose a similar tax on interstate motor carriers based in the state of Nebraska and without real property, assets or employees in this state, now, therefore,

Be It Resolved by the House of Representatives of the Sixty-seventh General Assembly of the State of Colorado, the Senate concurring herein:

That, should the state of Nebraska persist in its campaign to subject interstate motor carriers based in Colorado to such unwarranted taxation, the Colorado Department of Revenue is hereby directed to impose a similar tax, under existing Colorado statute and the regulations of the Department, upon interstate motor carriers based in Nebraska and traveling on the roads and highways of this state.

Statement for the Record

On behalf of

Beall's Inc. & Subsidiaries

1806 38th Avenue East
Bradenton, FL 34208

Before the

United States Senate Committee on Finance

April 25, 2012

Beall's Inc. appreciates the opportunity to submit a statement for the record of the Senate Finance Committee hearing on "Tax Reform: What it Means for State and Local Tax and Fiscal Policy." Beall's has a great interest in clarifying the nexus rules that govern the states' ability to impose business activity taxes on non-resident companies. To that end, we strongly urge that Congress enact H.R. 1439, the Business Activity Tax Simplification Act ("BATSA").

The U.S. Constitution prohibits the states from imposing any tax on an out-of-state business unless that business has a "substantial nexus" with the taxing jurisdiction. In the context of state sales and use taxes, the U.S. Supreme Court has construed such "substantial nexus" requirement to mean that a business must have more than a *de minimis* physical presence in a state before it can be required to collect and remit that state's sales or use taxes. *See* Quill Corp. v. North Dakota, 504 U.S. 298 (1992); National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967). The state courts that have considered the issue are split on whether the physical presence test, articulated by the U.S. Supreme Court in the context of sales and use taxes, applies equally to business activity taxes.

Over the past several years, a number of states have become increasingly aggressive and creative in attempting to expand the reach of their business activity taxes to burden companies that have no connection to the taxing jurisdiction. Those states have adopted so-called economic nexus theories in an effort to tax the income of out-of-state corporations carrying on virtually no income-producing activity in those jurisdictions. It is easy to see the appeal to a state in collecting revenue from non-residents, however, such tax assessments unconstitutionally burden interstate commerce.

Beall's strongly supports enactment of BATSA as a means of clarifying the appropriate business activity tax nexus standard. BATSA would make clear that a state can impose corporate income and similar taxes only on companies that have a meaningful presence in the taxing jurisdiction. Pursuant to the bill, a state or locality cannot impose a business

activity tax on a company unless that business has a physical presence (such as employees, an office or property that is either leased or owned) in that state for more than fourteen days in a taxable year. The bill protects businesses from business activity taxation if the company merely solicits sales in the state or enters the state only to purchase goods or property. The bill would not impose any new restriction on the states' taxing power, but would merely clarify the states' existing authority to tax interstate commerce.

BATSA would apply to all direct taxes levied by states. This includes income taxes, gross receipts taxes, gross profits taxes, single business taxes, franchise taxes, capital stock taxes and business and occupation taxes. BATSA would not apply to transaction taxes based on gross receipts, such as sales and use taxes or gross premium charges on insurance companies.

The Congressional Budget Office did not score the federal revenue impact of H.R. 1439 in the current Congress because of a change in its scoring protocols. But, in a previous Congress, CBO estimated that BATSA would increase federal revenue by $3.1 billion over 10 years. The revenue would result from lower federal deductions for state and local tax assessments that would be disallowed if the bill were enacted. In short, if BATSA became law, our ballooning federal deficit would decline.

Moreover, enactment of BATSA would lead to greater investment in U.S. business growth and jobs by clarifying the standards for the imposition of business activity taxes by states and localities on multistate businesses and by resolving widespread uncertainty caused by inconsistent and ambiguous state interpretations of the constitutional standard for state taxation of interstate commerce.

It is time for Congress to step in and put a stop to aggressive state taxation that threatens interstate commerce. We respectfully urge Congress to address this issue this year by enacting BATSA into law.

United States Senate
Committee on Finance

Hearing on

"Tax Reform: What it Means for State and Local Fiscal Policy"

April 25, 2012

Statement Submitted by:
Bond Dealers of America
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Ste. 750
Washington, DC 20036
Ph: 202-204-7901

Mike Nicholas,
Chief Executive Officer

The Bond Dealers of America (BDA) is pleased to submit this statement to the United States Senate Finance Committee as a part of its written record of the April 25, 2012 hearing to examine "Tax Reform: What it Means for State and Local Fiscal Policy."

The Bond Dealers of America is the only Washington, DC-based organization that represents the unique legislative and regulatory interests of national, middle-market dealers of fixed-income securities. BDA members work directly with municipal and state governments and financing agencies to facilitate the flow of capital used to fund capital projects that are critical to the economic livelihood and employment base throughout the country.

BDA members work closely with municipal and state governments to facilitate the issuance of municipal bonds—including tax-exempt bonds, tax-credit bonds, bank-qualified bonds, direct subsidy bonds and refundings. BDA broker/dealers often act as advisors to governments to assist them in determining which type of bond is the most effective from both financing and tax perspectives.

Tax-exempt municipal bonds are the cornerstone of state and municipal finance. Tax-exempt municipal bonds are the most accessible and effective source of financing for state and local governments. Currently, there is $3.7 trillion worth of capital in the municipal market, with roughly 70 percent of the outstanding bonds held by individuals either through direct investment or indirectly through mutual funds. Tax-exempt bonds are issued by thousands of governmental entities, including States, counties, cities, municipal water, sewer, and electric utilities, and agencies formed for various other purposes including health care, higher education, airports, ports, and housing. Nearly all long-term tax-exempt bonds are issued to finance capital expenditures. Short-term borrowings are used by some cities, counties, and States to help better match expenditures with tax revenues, since tax revenues may come in unevenly throughout the year.

Interest on municipal bonds has been exempt from federal income tax since the first federal tax code was adopted in 1913. Throughout dozens of tax debates, Congress has chosen again and again to preserve the tax-exemption for municipal debt as a sign of the federal government's commitment to maintain the delicate balance between the federal and state governments and to sustain the state and local government role in contributing to a strong national economy.

The importance of retaining the current tax law treatment for municipal bonds. Proposals to limit or eliminate the tax-exemption for municipal bonds have grown out of debate at the federal level on ways to reduce the federal debt and deficit to put the federal government on a path to fiscal stability. The current Administration has proposed limiting the value of itemized deductions (including tax-exempt interest) to 28 percent for individuals in the highest income class. The Simpson-Bowles Commission recommended elimination of the federal tax deduction for tax-exempt interest. These proposals have been structured to raise a significant amount of revenue for the federal government and to, in the case of the Administration's proposal, insure that all income classes receive a commensurate benefit from the deduction.

BDA believes proposals to limit or eliminate the tax-exempt status for municipal bonds are misguided from both economic and policy perspectives. Economically, state and local

governments are just now beginning to emerge from the recession and are rebuilding their historically strong balance sheets. Unlike the federal government, every state (except Vermont) is required by its state constitution to annually balance its budget. States cannot sell debt to finance budget gaps and must turn to spending cuts or tax increases to balance their books. These fiscal restrictions combined with an increasing responsibility passed down from the federal government to fund federal programs like Medicaid and education have strapped many state and local government treasuries. For decades, state and local governments have relied upon effective, low-cost tax-exempt municipal bonds as a means to fund capital projects that provide critical services and create jobs—and the billions of dollars in financing costs governments have saved by utilizing tax-exempt financing has been used by state and local governments to fund and expand capital projects, maintain essential programs, or reduce taxpayer burdens.

BDA believes—unequivocably—for these simple reasons that the current tax law treatment of interest on municipal bonds must remain unchanged. Eliminating this valuable exemption would rattle capital markets, dramatically increase the cost of financing infrastructure improvements across the country, and force state and local governments to shift billions of dollars of increased financing and administrative costs to taxpayers in the form of higher taxes or higher user fees—not just to taxpayers who invest in bonds, but *every* taxpayer.

The Potential Impact of Limiting or Eliminating the Tax-Exemption for Municipal Bonds. All levels of government benefit from a vibrant, stable capital market for financing state and local government infrastructure. The benefits of tax-exempt financing are well-documented whereas the potential risks of instability are sometimes ignored.

a. The cost of financing capital projects could increase exponentially. It is indisputable that limiting or eliminating the tax-exemption for interest on municipal bonds would increase the cost of municipal debt and hinder infrastructure development. Without access to tax-exempt financing, market analysts estimate the yields that state and local governments would be compelled to pay to attract investors could increase as much as 25-50 basis points, which may make projects too expensive to undertake or could force state and local governments to defer or downsize some infrastructure projects. Additionally, yields on debt may need to rise even further if investors abandon municipal bonds in favor of higher yields in corporate bonds or other investment vehicles. Such activity could leave state and local governments without adequate sources of cost-effective financing to devote to capital projects.

b. Taxpayers—not governments—would bear the increased costs of financing. In a municipal market worth $3.7 trillion, state and local governments have been able to save over $700 billion in financing costs directly tied to tax-exempt bonds. If tax-exempt municipal bonds are eliminated as a financing mechanism for capital projects, state and local governments and issuers will have little choice but to use more expensive forms of capital financing (i.e., taxable bonds and tax-credit bonds) and pass-on additional financing costs they incur to every taxpayer in the form of higher taxes and fees (for example, higher property taxes, sales taxes, and utility fees).

c. Small issuers will lose market access. Tax-exempt municipal bonds are widely used by state and local governments, but, nationwide, local government issuances of these bonds outpace

those issued at the state level. In 2011, 55 percent ($155.9 Billion) of tax-exempt bonds were issued by local governments, while 42 percent ($120.7 Billion) were issued at the state level. (Educational institutions, direct issuers and electric cooperatives account for the remaining 4 percent ($11.1 Billion).[1] The use of tax-exempt financing by small communities represents a key component in their fiscal plans. Requiring small communities to issue taxable rather than tax-exempt debt could increase interest costs by 25 percent. Issuance costs can be further impacted by the frequency that an issuer goes to market, e.g. municipalities that issue bonds less often and whose credit standing is not analyzed frequently could face higher administrative costs and yield demands than large issuers whose fiscal condition is well-known to investors and underwriters. Further, without access to the tax-exempt market, small issuers will find it increasingly difficult to compete for investors in other markets as the attractive nature of large issuances offered by states or metropolitan cities will overshadow those of small issuers, further driving-up yields and the cost of financing in general.

Summary

The municipal market is the backbone of state and local government finance and a key component in a vibrant federal economy. Congress and the Administration must continue to recognize the vital role that municipal bonds play in providing states and municipalities with cost-effective financing for capital projects, including roads, bridges, schools, community health and higher education facilities. Insuring that states and municipalities can continue to fund capital projects by effective means reduces the burden on every taxpayer and all levels of government. Bond Dealers of America urges Congress to reaffirm nearly 100 years of federal tax law by retaining the current tax law treatment of municipal bonds.

[1] Source: Thomson Reuters (based on data available on April 9, 2012).

CARDOZO

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April 30, 2012

Senate Committee on Finance
Attn: Editorial and Document Section
Rm. SD-219
Dirksen Senate Office Building
Washington, DC 20510-6200

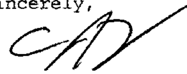
Dear sirs:

Enclosed please find a statement for inclusion in the record of the Committee's hearing held on April 25, 2012 under the title "Tax Reform: What It Means for State and Local Tax and Fiscal Policy."

Please do not hesitate to contact me if there is any question about the enclosed statement.

Many thanks.

Sincerely,



Edward A. Zelinsky
Morris and Annie Trachman
Professor of Law

Statement of Professor Edward A. Zelinsky[1] Supporting the Telecommuter Tax Fairness Act

I thank the Senate Finance Committee for the opportunity to submit a statement for the record of the Committee's hearing held on April 25, 2012 under the title "Tax Reform: What It Means for State and Local Tax and Fiscal Policy." I urge that the Committee pass and send to the full Senate the Telecommuter Tax Fairness Act of 2011,[2] introduced by Senator Lieberman and cosponsored by Senator Blumenthal. This Act responds to the growing national importance of telecommuting and the need to prevent other states from emulating New York's destructive double taxation of nonresident telecommuters.

By way of background, I am the Morris and Annie Trachman Professor of Law at the Benjamin N. Cardozo School of Law of Yeshiva University - though the views I present in this statement are my personal opinions. I teach and write in the area of state and local taxation and was also the taxpayer in *Zelinsky v. Tax Appeals Tribunal*.[3] In that case, I challenged New York's double income taxation of nonresident telecommuters on the days they work at their out-of-state homes. The Telecommuter Tax Fairness Act, if enacted into law, would bar such double taxation by New York and other states.

New York's double income taxation of nonresident telecommuters defeats our national interests even as such double taxation damages the Empire State's own economy. The Telecommuter Tax Fairness Act would end the double taxation of nonresident telecommuters and would preclude other states from emulating New York's destructive tax practices in this area.

Congress in the past has used its authority under the Commerce Clause to curb similarly dysfunctional state tax policies.[4] Congress should use that authority today by enacting

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[1] Edward A. Zelinsky is the Morris and Annie Trachman Professor of Law at the Benjamin N. Cardozo School of Law of Yeshiva University. His office address is Room 941, 55 Fifth Avenue, New York, New York 10003.

[2] S. 1811.

[3] 1 N.Y.3d 85, cert. denied, 541 U.S. 1009 (2004).

[4] *See, e.g.,* 4 U.S.C. § 114 (forbidding a state from taxing "any retirement income of an individual" unless such individual

the Telecommuter Tax Fairness Act and thereby ensure that nonresident telecommuters are not double income taxed on the days they work at home.

The first section of this statement provides the background to the Act. In this first section, I discuss New York's "convenience of the employer" doctrine which authorizes double income taxation of nonresident telecommuters, my litigation against such taxation, the unconstitutionality of such double taxation under the Due Process and Commerce Clauses, and the strong scholarly consensus against the double taxation of nonresident telecommuters caused by the convenience of the employer rule. In the next section, I summarize the major provisions of the Telecommuter Tax Fairness Act.

In the third and final section of this statement I address the testimony to the Committee of Professor Walter Hellerstein. Professor Hellerstein agrees that the employer convenience doctrine is unconstitutional and is bad tax policy because of the double taxation it causes but thinks there are higher priorities for Congress to address. For two reasons, I disagree with my colleague on this latter point and contend that the problem of the double taxation of nonresident telecommuters deserves Congress' immediate attention. Telecommuting is an important and valuable national trend which should be taxed by the states in a fair and sensible manner. Moreover, Congress' failure to pass the Telecommuter Tax Fairness Act will, in the not too distant future, lead to a race-to-the-bottom as other states emulate New York's unconstitutional and ill-considered double income taxation of nonresident telecommuters on the days they work at their out-of-state homes.

Consequently, the Committee should view passage of the Act as a high national priority. The Telecommuter Tax Fairness Act is important because telecommuting is important.

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is "a resident or domiciliary of such State").

Background: "Convenience of the Employer"

I did not set out to become the poster boy for the evils of double taxing nonresident telecommuters. It just turned out that way. As noted above, I am a law professor at Yeshiva University's Cardozo School of Law.[5] State and local taxation is among the areas in which I teach and write. I live in New Haven, Connecticut. During the semester, I commute on three days each week to Manhattan to teach at Cardozo. I spend my nonteaching days at my home in New Haven, Connecticut, researching, grading and writing. On the days when I research, grade and write at home, modern technology, e.g., email, cell phones, the internet, gives me access to legal databases and also permits me to stay in touch with my colleagues and students in Manhattan (and other locations) even though I am at home in Connecticut. My lifestyle thus exemplifies the benefits to me and to the society at large of telecommuting, facilitated by contemporary technologies.

When New York, under its so-called "convenience of the employer" doctrine, sought to impose New York state income taxation for the days I worked at home in New Haven, I resisted. On the days when I write, grade and research at home, Connecticut, not New York, provides the public services I receive on those days. If I need an EMT when I work at home, it is Connecticut, not New York, which supplies that EMT. Connecticut, not New York, similarly provides me with police protection and sewage and water services on the days I work at home. Connecticut has a strong rationale for taxing the income I earn working at home, both because I am a Connecticut resident and because, on such days, Connecticut provides the public services I use.

Moreover, long-standing decisions of the U.S. Supreme Court restrict the taxing authority of the states to the income earned within their respective boundaries.[6] Implementing this restriction under the dormant Commerce Clause and the Due Process Clause of the U.S. Constitution, the Supreme Court has held that

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[5] To reiterate: This statement reflects my personal views. Neither Yeshiva University nor the Cardozo School of Law has reviewed or approved this statement.

[6] Oklahoma Tax Commission v. Chickasaw Nation, 515 U.S. 450, 463 n. 11 (1995) ("For nonresidents...jurisdictions generally may tax only income earned within the jurisdiction."); Cook v. Tait, 265 U.S. 47, 55 (1924) ("The taxing power of a State, it was decided, encountered at its borders the taxing power of other States and was limited by them.").

states must apportion the tax liabilities of nonresidents to avoid the kind of double taxation which New York inflicts on interstate telecommuters by taxing them on days they work at home and thus legitimately owe income taxes to their home states. Under the rule of apportionment, each state with nexus to a nonresident may tax only that state's respective share of the nonresident's taxable activity.[7]

Despite these decisions of the U.S. Supreme Court, in *Zelinsky v. Tax Appeals Tribunal*[8] and again in *Huckaby v. New York State Division of Tax Appeals,*[9] New York's highest court refused to curb the so-called "convenience of the employer" doctrine under which New York double taxes nonresident telecommuters. In simplest terms, New York refuses to apportion, that is to say, New York insists on taxing all of my salary rather than the portion of my salary I earn on days when I teach within New York's borders.[10]

For the years involved in my litigation, Connecticut, as the state where I resided and which provided me with public services on the days I worked at home, legitimately taxed the income I earned on such days. New York, under its employer convenience rule, imposed a second state tax on the income I earned working at home in Connecticut. Neither state gave a credit for the

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[7] MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16, 24 (2008) ("The Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation"); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977) (tax on interstate commerce must be "fairly apportioned"); Central Greyhound Lines, Inc. v. Mealey, 334 U.S. 653, 663 (1948) (tax must be "fairly apportioned" between New York and other states).

[8] 1 N.Y.3d 85, cert. denied, 541 U.S. 1009 (2004).

[9] 4 N.Y.3d 427, cert. denied, 546 U.S. 976 (2005).

[10] For a more extended discussion of the constitutional and practical problems caused by the double taxation of nonresident telecommuters' incomes, *see* Edward A. Zelinsky, *New York's "Convenience of the Employer" Rule is Unconstitutional,"* 48 STATE TAX NOTES 553 (2008). *See, also,* Edward A. Zelinsky, *Swine Flu, Telecommuting and New York's Extraterritorial Taxation of Nonresidents' Incomes*, OUPblog, http://blog.oup.com/2009/05/swine-flu/.

income taxes I paid to the other. The double income taxation which resulted imposes a substantial burden on telecommuting at precisely the time we should instead be encouraging telecommuting to reduce congestion and to expand employment opportunities for the parents of young children, for the physically handicapped, and for individuals who live far from metropolitan work centers.

The Telecommuter Tax Fairness Act, if enacted into law, would overturn *Zelinsky*, *Huckaby* and other decisions of the New York courts upholding the Empire State's double income taxation of nonresident telecommuters. As discussed below, the Act would accomplish this by forbidding the state taxation of a nonresident's income unless such income is earned by the nonresident's physical presence in the taxing state. The Act would preclude all states from utilizing "the convenience of the employer" doctrine or similar rules to double tax nonresident telecommuters on the days they work at their out-of-state homes.

The problem of such double taxation is of nationwide significance and is not limited to the New York metropolitan area. Mr. Huckaby was telecommuting from his home in Nashville, Tennessee but New York taxed him under the employer convenience rubric for the income he earned working at home in Tennessee - even though Mr. Huckaby is a Tennessee resident and Tennessee (not New York) provided Mr. Huckaby's public services on the days he worked at home in Nashville. New York similarly taxed Mr. Kakar under the employer convenience banner on days he worked at home in Arizona.[11] These are not isolated cases but, rather, reflect New York's deliberate projection of its taxing authority beyond its borders to tax telecommuters throughout the nation under New York's "convenience of the employer" doctrine.

As my case and those of countless other telecommuters demonstrate, Congress must enforce the apportionment principle in these settings so that all states tax only within their borders and tax only their respective portions of the taxable incomes of nonresident telecommuters. The Telecommuter Tax Fairness Act would require, in a case like mine, that New York apportion, that is to say, tax only the portion of my income earned on the days I am physically present teaching in New York. The Act would thereby eliminate the double taxation caused by New York's "convenience of the employer" rule, a rule more properly labeled "the no-apportionment/double tax" rule.

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[11] In the Matter of the Petition of Manohar and Asha Kakar, DTA No. 820440 (February 16, 2006), 2006 STATE TAX TODAY 41-23.

I served in both the legislative and executive branches of New Haven's city government. From these experiences and from a philosophic commitment to federalism, I believe in the self-government of states and their localities. However, our system of federalism requires the national government to umpire when particular states overreach. That is why the Constitution authorizes Congress to supervise interstate commerce under the Commerce Clause rather than permitting each state to erect tax and regulatory barriers impeding the movement of people, capital and ideas across state boundaries.

Nicole Belson Goluboff is the leading legal commentator on telecommuting and a critic of the double income taxation of telecommuters caused by New York's employer convenience rule. She observes that telecommuting both facilitates work by important segments of the population and implements important social policies including traffic reduction and livability.[12] In terms of constitutionality, Professor Hellerstein concludes that New York's employer convenience doctrine "ignores the distinction between the state's" plenary authority to tax all of a resident's income and its more limited, source-based power to tax the income of a nonresident.[13] On days when nonresidents work at their out-of-state homes, New York is not "providing benefits or protections with respect to the production of [the nonresident's] income"[14] and thus lacks the constitutional authority to tax that income:

> Because there can be no serious dispute concerning the power of a state where an employee performs his services to tax the employee's income from such services, the state of the employee's base of operations would appear to lack the power to tax such income on an unapportioned basis.[15]

Similarly, Professor Morgan L. Holcomb argues that "the *Zelinsky* court erred" in sustaining the employer convenience

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[12] Nicole Belson Goluboff, *The Telecommuter Tax Fairness Act Is Back, and the Climate Is Right*, 44 STATE TAX NOTES 109 (2007).

[13] Walter Hellerstein, STATE TAXATION (3rd ed. 2007) at para. 20.05[4][e].

[14] *Id.*

[15] *Id.*

doctrine against Commerce Clause challenge.[16] So too Professor William V. Vetter observes that, under the dormant Commerce Clause, the employer convenience doctrine flunks the external consistency requirement for a properly apportioned tax:

> [T]he "convenience of the employer" rule necessarily creates the risk of multiple taxation...A rule that creates a recognizable risk of double taxation does not pass the external consistency test and is therefore void under Commerce Clause principles. Eliminating the risk is the enacting state's duty and is not to be foisted on to other states.[17]

The Telecommuter Tax Fairness Act

If enacted into law, the Telecommuter Tax Fairness Act would prevent New York or any other state from taxing nonresident telecommuters on the days they work at their out-of-state homes. Specifically, under the Act, a state could only tax income earned by any "nonresident individual" if such nonresident earns such income by being "physically present" in such state.[18] Thus, in cases like mine,[19] Mr. Huckaby's[20] and Mr. Kakar's,[21] New York (or any other state) could only tax the income we earn while

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[16] Morgan L. Holcomb, *Tax My Ride: Taxing Commuters in our National Economy*, University of Minnesota Law School, Legal Studies Research Paper Series, Research Paper No. 07-36, 2007, at 43, available at http://ssrn.com/abstract=1007088. *See also* Morgan L. Holcomb, *Tax My Ride: Taxing Commuters in Our National Economy*, 46 STATE TAX NOTES 679 (2007)(hereinafter, Holcomb, "STN").

[17] William V. Vetter, *New York's Convenience of the Employer Rule Conveniently Collects Cash From Nonresidents, Part 2*, 42 STATE TAX NOTES 229, 238 (2006) (emphasis omitted).

[18] The Telecommuter Tax Fairness Act of 2011, S.1811, § 2(a) (adding proposed 4 U.S.C. § 127(a)).

[19] 1 N.Y.3d 85, cert. denied, 541 U.S. 1009 (2004).

[20] 4 N.Y.3d 427, cert. denied, 546 U.S. 976 (2005).

[21] In the Matter of the Petition of Manohar and Asha Kakar, DTA No. 820440 (February 16, 2006), 2006 STATE TAX TODAY 41-23.

physically present in that state, not the income we earn working at our out-of-state residences. This would eliminate the double taxation of nonresident telecommuters on the days they work at their out-of-state homes.

To protect this physical presence requirement for nonresident income taxation, the Act, if it became law, would explicitly prevent a state from utilizing "any convenience of the employer test or any similar test" to "deem a nonresident individual to be present in or working in such State."[22] Also to protect the physical presence rule for state taxation of nonresidents' incomes, the Act would prevent a state from taxing a nonresident by disregarding the nonresident's "work time" in another state.[23] Thus, for example, on a Wednesday when I research and write at my home in New Haven, Connecticut, New York could not tax the income Cardozo pays me on that day, either through a "convenience of the employer" test or by declaring that that is not a normal work day for me as a law professor and that my salary for that day must be allocated to a teaching day when I am physically present in New York.

The Act would protect from double taxation income earned by a nonresident either as an employee or as an independent contractor.[24]

Professor Hellerstein's Testimony

As noted above, Professor Hellerstein joins the scholarly consensus which holds that New York's double taxation of telecommuting nonresidents under the employer convenience banner is unconstitutional.[25] He reiterates that conclusion in his written testimony before the Committee by saying that he agrees with the Telecommunter Tax Fairness Act "as a matter of principle."[26] However, Professor Hellerstein suggests that

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[22] The Telecommuter Tax Fairness Act of 2011, S.1811, § 2(a) (adding proposed 4 U.S.C. § 127(b)).

[23] *Id.* (adding proposed 4 U.S.C. § 127(c)).

[24] *Id.* (adding proposed 4 U.S.C. § 127(d)(7)).

[25] Walter Hellerstein, STATE TAXATION (3rd ed. 2007) at para. 20.05[4][e].

[26] Testimony of Walter Hellerstein at page 31.

Congress currently has more pressing priorities in this area.[27]

I agree with Professor Hellerstein that there are many vital questions in this area which Congress must address.[28] However, for two reasons, I contend that passage of the Telecommuter Tax Fairness Act should be a high priority. First, the Act is important because telecommuting is important. This valuable national trend should be taxed by the states in a fair and sensible manner. However, Congress' failure to legislate is effectively an invitation to the states to emulate New York's destructive and unconstitutional double taxation of nonresident telecommuters on the days such telecommuters work at their out-of-state homes.

Hence, the second reason the Telecommuter Tax Fairness Act should be a high priority for this Committee and for Congress as a whole: Failure to pass this Act into law will, in the not too distant future, lead to a race-to-the-bottom as other states follow New York's unconstitutional and ill-considered double income taxation of nonresident telecommuters.

Conclusion

Congress should use its Commerce Clause authority to enact The Telecommuter Tax Fairness Act and thereby declare a strong national policy encouraging telecommuting across state lines. Telecommuting is an important element of a national strategy to reduce traffic, make our metropolitan areas more livable and open employment opportunities. The Telecommuter Tax Fairness Act, by forbidding states from double income taxing nonresident telecommuters, would further these important policies. The Act should be an important priority for this Committee and for Congress as a whole.

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[27] *Id.*

[28] It is, for example, important for Congress to give the states the authority to collect their respective sales and use taxes as to internet and mail order sales. Edward A. Zelinsky, *California's Once and Future "Amazon" Law,* 62 STATE TAX NOTES 83, 97 (2011). *See, also,* Edward A. Zelinsky, *The Lesson of the 2009 Holiday Shopping Season: Tax Internet Sales*, OUPblog, http://blog.oup.com/2010/01/tax-internet-sales/.

Comments for the Record

Senate Finance Committee

Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Wednesday, April 25, 2012, 10:00 AM

By Michael G. Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, VA 22304

Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to submit these comments for the record to the Senate Finance Committee. As always, our comments are in the context of our four part tax reform plan:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

Our proposals have several impacts on state and local tax and fiscal policy. Those states with fixed conformity provisions regarding income taxation in law or their constitutions will be greatly affected by enactment of a simplified income tax which treats distributions from inheritance as normal income. Indeed, if they do not enact similar reform, which includes a much higher income floor for filing, many more heirs will be touched by this provision than in federal law. As most state income tax rate structures are much less progressive than the federal system, many states will be able to abandon income taxation altogether, possibly increasing use of Land Value Taxes if some form of redistributive tax is still desired.

If the basic structure of reform is adopted in the states, the biggest change will be the need for a common base between federal and state consumption taxes. Shifting from retail sales taxes and gross receipts taxes to value added taxes and VAT-like net business receipts taxes will change the nature of most state taxation, while enabling ease of collection of taxes on online sales, since taxes would be levied at every stage of the production process.

If a common base agreement can be negotiated for these taxes, state treasurers can collect both their own taxes and the federal taxes, as well as analytical information on tax credit usage, which can then be shared with the U.S. Internal Revenue Service in order to track income accruing to payers of the federal high income surtax, as well as to recipients of the federal child tax credit, which would be paid to employees with wages under the NBRT and then verified by a mailing from both the employer and the Internal Revenue Service, with employees verifying that their employees paid every dollar to them reported as a credit.

Our hope is that states would match the Child Tax Credit at a level consistent with their cost of living. Some states might even include higher credits for certain high-cost counties, for instance, Northern Virginia.

The NBRT at both the state and federal levels should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

States may also include several of the educational and social service credits recommended under our proposal. The NBRT could be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. This is a feature that is impossible with the FairTax or a VAT alone.

To extract health care cost savings under the NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit, provided that services are at least as generous as the current programs. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed. Increasing Part B and Part D premiums also makes it more likely that an employer-based system will be supported by retirees.

Enacting the NBRT is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

There will be no impact on the states of FICA reforms, except to the extent that our suggested reforms yield a higher base benefit for seniors, which will decrease their need for state social service benefits.

Income tax simplification will eliminate the deduction for state income and property taxes. The extent to which state income taxes are eliminated will also eliminate the demand for these, although if states adopt higher land value taxes for redistributive purposes, some residual deduction for this tax may need to be included in the federal tax code, although doing so will simply require higher federal rates to make up the difference. Additionally, abandonment of the state income tax deduction has been seen as a reason to entirely federalize Medicaid as an offset. Doing so may be appropriate, however if participants in subsidized and paid adult education are covered by the provider's insurance as if employees and retirees long term care needs are increasingly covered by the firms they retired from as an offset to Net Business Receipts Taxes, the question of funding Medicaid may be a minor footnote.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

COALITION FOR
RATIONAL
AND
FAIR
TAXATION
c/o McDermott Will & Emery LLP
340 Madison Avenue
New York, NY 10173

April 25, 2012

Senator Max Baucus, Chairman
Senator Orrin Hatch, Ranking Member
Senate Committee on Finance
United States Senate
215 Dirksen Senate Office Building
Washington, DC 20002

Re: Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Dear Chairman Baucus and Ranking Member Hatch:

Thank you for the opportunity to submit this statement for the record for the April 25, 2012 hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy on behalf of the Coalition for Rational and Fair Taxation ("CRAFT"). CRAFT is a diverse coalition of some of America's major corporations involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and multistate entertainment and service businesses. CRAFT members operate throughout the United States, employ hundreds of thousands of American workers and generate billions of dollars for the nation's economy. While the hearing concerns many state and local tax issues that apply to CRAFT members and other businesses involved in interstate commerce, CRAFT members are particularly concerned about the lack of a national standard regarding when states and localities may tax out-of-state businesses.

CRAFT believes that the bright-line, quantifiable physical presence nexus standard, as provided in the business activity tax simplification act ("BATSA"), introduced as the Business Activity Tax Simplification Act of 2011, H.R. 1439, is the appropriate standard for state and local taxation of out-of-state businesses. Further, CRAFT believes that the modernization of Public Law 86-272, as BATSA would accomplish, is essential for the health and growth of the American economy. In today's electronic commerce world, maintaining the physical presence standard is more important than ever; while businesses can have customers in other states, the governments of those other states still provide protections only to businesses and residents that are physically located within their borders. Therefore, CRAFT strongly supports BATSA and respectfully urges the approval of this legislation for consideration by the full Congress and ultimate enactment. CRAFT believes that it is essential for Congress to provide clear guidance to the states in the area of state taxing jurisdiction, remove the drag that the current climate of

uncertainty and unpredictability places on American businesses, and thereby protect American jobs and enhance the American economy.

I. BACKGROUND

The principal motivation for the adoption of the United States Constitution as a replacement to the Articles of Confederation was a desire to establish and ensure the maintenance of a single, integrated, robust American economy. This is reflected in the Commerce Clause, which provides Congress with the authority to safeguard the free flow of interstate commerce. Enacting legislation regarding states and localities imposing, regulating, or removing tax burdens placed on transactions in interstate commerce is not only within Congress' realm of authority, it is also – we respectfully submit – Congress' responsibility.

Unfortunately, some state revenue departments and state legislatures have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on out-of-state businesses that have little or no connection with their state. Specifically, some state revenue departments have asserted that they can tax a business based merely on its economic presence in the state – such as the presence of customers – based on the recently-minted notion of "economic nexus." The "economic nexus" concept flies in the face of the current state of business activity taxation, which is largely based on the eminently valid notion that a business should only be subject to tax by a state from which the business receives benefits and protections. And worse, it creates significant uncertainty that has a chilling effect on interstate economic activity, dampening business expansion and job growth. As a practicing attorney, I regularly advise businesses that ultimately decide not to engage in a particular transaction out of concern that they might become subject to tax liability in that state. It is entirely appropriate for Congress to intervene to prevent individual states from erecting such barriers to trade, and to protect and promote the free flow of commerce between the states for the benefit of the American economy.[1]

There can be no doubt that the rapid growth of electronic commerce continues to drastically alter the shape of the American and global economies. As businesses adapt to the "new order" of conducting business, efforts by state revenue departments to expand their taxing jurisdiction to cover activities conducted in other jurisdictions constitute a significant burden on the business community's ability to carry on business. Left unchecked, this attempted expansion of the states' taxing power will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation, and uncertainty escalate. Clearly, the time is ripe for Congress to consider when state and local governments should and should not be permitted to require out-of-state businesses to pay business activity taxes. It appears eminently fair and reasonable for Congress to provide relief from unfair and unreasonable impositions of business activity taxes on out-of-state businesses that have little or no physical connection with the state or locality.

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[1] *See, e.g.*, Diann L. Smith, *Supreme Court Would Uphold P.L. 86-272* (letter to the editors), 25 State Tax Notes 135 (July 8, 2002) (discussing the authority of Congress to regulate interstate commerce).

Confronted with aggressive – and often constitutionally questionable – efforts of state revenue departments to tax their income when they have little or no presence in the jurisdiction, American businesses are faced with a difficult choice. They can challenge the specific tax imposition – but must bear substantial litigation costs to do so. Or, they can knuckle under to the state revenue departments and pay the asserted tax – but then they risk being subject to multiple taxation and risk violating their fiduciary responsibilities to their shareholders (by paying invalid taxes) and hence, become subject to shareholder lawsuits. Unfortunately, the latter choice is sometimes made, especially since some state revenue departments are utilizing "hardball" tactics.[2] Moreover, the compliance burdens of state business activity taxation can be immense. Think of an interstate business with customers in all 50 states. A recent study found that over 3,000 state and local taxing jurisdictions currently impose some type of business activity tax, and thousands more have the authority to impose such taxes but do not currently do so.[3] If economic nexus were the standard, that business would be faced with having to file an income or franchise tax return with every state, and pay license or similar taxes to thousands of localities.

BATSA is designed to address the issue of when a state should have authority to impose a direct tax on a business that has no or only a minimal connection to the state. BATSA applies to state and local business activity taxes, which are direct taxes that are imposed on businesses engaged in interstate commerce, such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes. BATSA does not apply to other taxes, like personal income taxes, gross premium taxes imposed on insurance companies, sales and use taxes or other transaction taxes.

The underlying principle of this legislation is that only states and localities that provide meaningful benefits and protections to a business – like education, roads, fire and police protection, water, sewers, etc. – should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. Further, businesses should only pay tax to those states and localities where they *earn* their income, and income is only earned where a business is actually located. By imposing a physical presence standard for business activity taxes, BATSA ensures that the economic burden of state tax impositions is appropriately borne only by those businesses that receive such benefits and protection from the taxing state and ensures that businesses pay these taxes only to those states and localities where they have earned income. Perhaps most important, BATSA's physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners.

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[2] *See, e.g.*, *Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the House Comm. on Small Business*, 110th Cong. (2008) (testimony of Barry Godwin, on behalf of National Marine Manufacturers Association).

[3] Ernst & Young, *State and Local Jurisdictions Imposing Income, Franchise, and Gross Receipts Taxes on Business* (March 7, 2007).

A. *A BRIEF HISTORY*

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state is a long-standing issue in constitutional jurisprudence.[4] In many ways, the issues BATSA seeks to resolve first came to the fore in a 1959 United States Supreme Court decision. In *Northwestern States Portland Cement*, the Supreme Court ruled that a corporation with several sales people assigned to an office located in the State of Minnesota could be subjected to that state's direct tax scheme,[5] overturning a "well-settled rule...that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place."[6] As a result, Congress responded rapidly, enacting Public Law 86-272 a mere six months later. Public Law 86-272 prohibits states and localities from imposing income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state.[7] Subsequently, the Congressional Willis Commission studied this and other interstate tax issues and concluded that, among other things, a business should not be subject to a direct tax imposition by a state in which it merely had customers.[8]

B. *WHERE WE ARE TODAY*

Nearly fifty years later, we are no closer to a definitive answer as to when may the states impose their business activity taxes on out-of-state businesses. In recent years, certain states and state revenue department organizations have been advocating the position that a state has the right to impose tax on a business that merely has customers there, even if the business has no physical presence in the state whatsoever.[9] This "economic nexus" argument marks a departure from what businesses and other states have believed (and continue to believe) to be the proper jurisdictional standard for state taxation of business activity taxes. Specifically, CRAFT members believe that a state can impose direct taxes only on businesses that have a physical

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[4] *See, e.g.*, Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 Tax Law. 37 (1987).

[5] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

[6] *Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).

[7] P.L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).

[8] Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965), Vol. 1, Part VI., ch. 39, 42. *See also* W. Val Oveson, *Lessons in State Tax Simplification*, 2002 State Tax Today 18-39 (Jan. 20, 2002).

[9] A survey conducted by BNA Tax Analysts demonstrates the extent to which the states are asserting the right to impose tax on out-of-state businesses based on so-called "economic nexus" grounds. *Special Report: 2008 Survey of State Tax Departments*, 15 Multistate Tax. Rep't 4, pp. S-15 - S-53 (April 25, 2008). *See also Ensuring the Equity, Integrity and Viability of Multistate Tax Systems*, Multistate Tax Commission Policy Statement 01-2 (October 17, 2002). *Accord* Letter from Elizabeth Harchenko, Director, Oregon Department of Revenue, to Senator Ron Wyden (July 16, 2001). *See also* Doug Sheppard, *The Certainty of Disagreement on Business Activity Tax Nexus*, 25 State Tax Notes 420 (Aug. 5, 2002).

presence in the state.[10] Although this issue has been litigated, state courts and tribunals have rendered non-uniform decisions.[11] Unfortunately, the Supreme Court has not granted a writ of *certiorari* in any relevant case.[12]

The bottom line is that businesses should only pay tax where they *earn* income. It may be true that without sales there can be no income. But, while this may make for a nice sound bite, it simply is not relevant. Economists agree that income is earned where an individual or business entity employs its labor and capital, *i.e.*, where he, she or it actually performs work.[13]

Proponents of an economic nexus standard argue that the states provide benefits for the welfare of society as a whole and, therefore, the states should be able to collect tax from all U.S. businesses, wherever located. Such an argument is not only ludicrous, but it ignores the fact that businesses pay federal taxes for such general benefits and protections. Proponents of an economic nexus standard also argue that states have spent significant amounts of revenue to maintain an infrastructure for interstate commerce. But businesses only receive meaningful benefits and if they are actually located within a jurisdiction. Further, while a state government may expend resources to maintain an infrastructure for interstate commerce, it does so for the benefit of its constituents and not for the benefit of out-of-state sellers. Imposing business activity taxes on out-of-state businesses is truly "taxation without representation."[14]

II. BATSA PROVIDES AN APPROPRIATE SOLUTION

A. *PROVISIONS OF BATSA*

BATSA ensures fair and equitable taxation of out-of-state businesses by codifying the physical presence standard and by modernizing Public Law 86-272. BATSA codifies the physical presence standard through the following provisions:

- BATSA provides that a state or locality may not impose business activity taxes on businesses that do not have a "physical presence" within the taxing jurisdiction.

[10] *The Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary*, 108th Cong. (2004) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair Taxation, Jamie Van Fossen, Chair of Iowa House Ways and Means Committee, and Vernon T. Turner, Smithfield Foods, Inc.).

[11] *See,* Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction,* 46 State Tax Notes 387 (Nov. 5, 2007).

[12] *See, e.g., Geoffrey, Inc. v. Mass. Comm'r of Rev.*, 899 N.E.2d 87 (Mass. 2009), *cert denied* 2009 U.S. LEXIS 4584 (2009).

[13] As noted by one state tax expert, "'[i]ncome,' we were told long ago, 'may be defined as the gain derived from capital, from labor, or from both combined.'" W. Hellerstein, *On the Proposed Single-Factor Formula in Michigan,* State Tax Notes, Oct. 2, 1995, at 1000 (quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (1920)).

[14] Although a business with a physical presence may not vote, it is clearly part of the jurisdiction's local society and is able to have an impact on the government's policies and practices.

- BATSA provides exceptions for certain quantitatively and qualitatively de minimis activities in determining if the requisite physical presence requirement is met.[15]
- BATSA also provides that an out-of-state business will be considered to have a physical presence in a state whenever that business uses the services of an agent (excluding an employee) to perform services that establish or maintain the taxpayer's market in that state, but only if the agent does not perform business services in the state for any other person.[16]
- BATSA provides that, in the context of a consolidated/combined return, the group return can only include in its apportionment factor numerators the in-state apportionment factors from corporations that have a physical presence in the state.

BATSA also modernizes Public Law 86-272 through the following provisions:

- BATSA expands the protections of Public Law 86-272 to include all sales and transactions, not just sales of tangible personal property.[17]
- BATSA ensures that Public Law 86-272 covers all business activity taxes, not just net income taxes, and thereby prevents aggressive states from avoiding the restrictions on state taxing jurisdiction imposed by Public Law 86-272.[18]
- BATSA also provides that certain qualitatively de minimis activities will be protected by the modernized provisions of Public Law 86-272, including patronizing the local market (rather than exploiting the market) and mere information gathering.

B. *COMPARISON TO CURRENT COMMON LAW*

The physical presence nexus standard in BATSA is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Due Process Clause and the Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus"

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[15] Quantitatively, a business must have physical presence in a taxing jurisdiction for at least 15 days during a taxable year. Qualitatively, BATSA provides that presence in a state to conduct limited or transient activities will not be considered in determining whether a business has the requisite physical presence in the jurisdiction.

[16] Attribution of physical presence for business activity tax purposes has been allowed in only one U.S. Supreme Court case where the in-state person performed market enhancement activities and only when those activities were conducted for a single out-of-state person. *Tyler Pipe Industries Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232 (1987).

[17] It is important to note that the business activity tax nexus provisions of BATSA and Public Law 86-272 are two separate constraints on state taxation of interstate commerce and each law operates independently of the other. Thus, any activities protected by Public Law 86-272, as modernized by BATSA, will not create a physical presence for that business, regardless of whether the protected activities occur in the taxing jurisdiction for more than 15 days.

[18] Some states have attempted to avoid Public Law 86-272 by establishing taxes on business activity that are measured by means other than the net income of the business. Examples include the Ohio Commercial Activity Tax, which imposes a tax based on gross receipts, the Texas Margin Tax, which imposes a tax based on "gross margin" (i.e., total revenues less either cost of goods sold or compensation), and the Michigan Business Tax which has a modified gross receipts component.

between the taxing state and the putative taxpayer, whereas the Due Process Clause requires only a "minimum" connection. In *Quill*, the Supreme Court determined that, in the context of a business collecting sales and use taxes from its customers, the substantial nexus requirement could be satisfied only by the taxpayer having a non *de minimis* physical presence in the state; the Court refrained from articulating the appropriate measure for business activity taxes.[19] The Supreme Court has not granted a writ of *certiorari* in a case that would permit it to address the business activity tax nexus issue.

Since the Supreme Court has not yet ruled on this issue, we must use clear logic and review what state courts and tribunals have recently decided. The answer is clear: if non-*de minimis* physical presence is the test for a mere collection and remission situation such as is the case for sales and use taxes, physical presence must be, at a bare minimum, the appropriate test for the imposition of direct taxes such as business activity taxes. Indeed, the standard for business activity taxes should, if anything, be ***higher*** than the standard for sales taxes for at least two reasons. First, a business activity tax is an actual direct tax, and not a mere obligation to collect tax from someone else.[20] Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes[21] Several of the state-level decisions on this issue have concluded that there is no principled reason for there to be any lower of a standard for business activity taxes than for sales and use taxes.[22] Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.[23]

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[19] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[20] "As an original matter, it might have been possible to distinguish between jurisdiction to tax and jurisdiction to compel collection of taxes as agent for the State, but we have rejected that." *Quill Corp. v. North Dakota*, 504 U.S. 298, 319 (U.S. 1992) (Scalia, J., concurring in part and concurring in the judgment) (citing *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977); *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960)). *See also National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977) ("Other fairly apportioned, non-discriminatory direct taxes have also been sustained when the taxes have been shown to be fairly related to the services provided the out-of-state seller by the taxing State. . . . The case for the validity of the imposition upon the out-of-state seller enjoying such services of a duty to collect a use tax is even stronger." (citations omitted)).

[21] *See, e.g.*, *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (U.S. 1977).

[22] This includes *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *America Online v. Johnson*, No. 97-3786-III, Tenn. Chancery Ct. (Mar. 13, 2001); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995), *reh'g denied*, 1996 Ala. Tax LEXIS 17 (Ala Dep't of Revenue Jan. 29, 1996) (*But see Lanzi v. State of Alabama Department of Revenue*, 968 So. 2d 18 (AL Ct. Civ. App. 2006)).

[23] *See* Gupta & Mills, *Does Disconformity In State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 Nat'l Tax J. 355 (June 2003) (discussing the compliance costs associated with state income taxes).

III. Other Considerations

A. *Federalism*

Contrary to the arguments of some opponents of clarifying the standards for state business activity taxes,[24] considerations of federalism support passing this legislation. A fundamental aspect of American federalism is that Congress has the authority and responsibility to ensure that interstate commerce is not burdened by state actions (including taxation of such commerce).[25] No one disagrees that tension exists between a state's authority to tax and the authority of Congress to regulate interstate commerce. However, the very adoption of the Constitution was itself a backlash against the ability of states to impede commerce between the states; in adopting the Constitution, which expressly grants Congress the authority to regulate interstate commerce, the states relinquished a portion of their sovereignty.[26] Moreover, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[27]

BATSA simply codifies the traditional jurisdictional standards for when a state or local government may impose a tax on a business engaged in interstate commerce. In essence, economic nexus allows one state to impose tax on activity that actually occurs in a sister state, therefore impinging on the sister state's jurisdiction to oversee and protect the business activities occurring within its borders. By codifying the physical presence standard, BATSA strikes the correct balance between state autonomy/sovereignty and interstate commerce.

B. *Effect on International Taxation and American Competitiveness*

Our country's own history and the federal government's position in the context of international taxation provide a strong reason to establish a physical presence nexus standard. Specifically, a physical presence nexus standard would promote consistency between international tax and state tax jurisdictional standards.

For over 80 years, the United States, along with most other countries in the world, has adopted and implemented a so-called "permanent establishment" standard in its income tax treaties with foreign jurisdictions. This "permanent establishment" standard is derived from the Model Tax Convention of the Organisation for Economic Co-operation and Development

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[24] *See, e.g., Federalism at Risk: A Report by the Multistate Tax Commission*, Multistate Tax Commission (June 2003); *Respecting Federalism*, Multistate Tax Commission Policy Statement 03-01.

[25] *See, e.g.,* Diann L. Smith, *Supreme Court Would Uphold P.L. 86-272* (letter to the editors), 25 State Tax Notes 135 (July 8, 2002) (discussing the authority of Congress to regulate interstate commerce).

[26] *See* Adam D. Thierer, *A Delicate Balance: Federalism, Interstate Commerce, and Economic Freedom in the Technological Age*, The Heritage Foundation (1998) (citing Alexander Hamilton, Federalist No. 22).

[27] *Barclay's Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *See also* Eugene F. Corrigan, *Searching for the Truth*, 26 State Tax Notes 677 (Dec. 9, 2002) ("No amount of state legislation of any kind can extend a state's taxing jurisdiction beyond the limits set by the Supreme Court; and that Court has, for all practical purposes, washed its hands of the matter, deferring it to Congress.").

("OECD").[28] Specifically, the OECD Model Tax Convention aims to limit double taxation, *i.e.*, situations in which a company is taxed both by the country in which the company is domiciled ("resident country") and by a country that is the source of all or part of the company's income ("source country").[29] Under the terms of the OECD Model Tax Convention, before a source country may impose a direct tax on a nonresident business' commercial profits, the foreign taxpayer must have a "permanent establishment" in the source country, which is defined generally as a fixed place of business through which the business of an enterprise is wholly or partly carried on.[30] In other words, the OECD Model Tax Convention employs a physical presence jurisdictional standard.[31]

Although this "permanent establishment" standard has been in place for many decades, the OECD was recently charged with revisiting the concept in light of electronic commerce and the changing global economy. After careful consideration, the OECD maintained its firm reliance on physical presence. Not only is BATSA's physical presence nexus standard consistent conceptually with the OECD "permanent establishment" jurisdictional standard, but BATSA's physical presence standard accomplishes the same policy goals by providing a bright-line standard that is clear and equitable. If a more expansive jurisdictional standard is adopted for state tax purposes than that used by the federal government for international tax purposes, it would surely dampen foreign investment in the United States.

Indeed, foreign businesses are often shocked to learn that while treaties may insulate them from federal taxation, state taxation can still be imposed. Addressing the problems of state tax uncertainty and the risk of litigation costs clearly has the potential to encourage additional foreign investment in the U.S., thus creating new jobs throughout the country.

IV. CONCLUSION

A physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy[32] and that is consistent with Public Law 86-272, a time-tested and valid Congressional policy. Physical presence is also an accepted standard for

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[28] Jerome B. Libin & Timothy H. Gillis, *It's a Small World After All: The Intersection of Tax Jurisdiction at International, National, and Subnational Levels*, 38 Ga. L. Rev. 197, 204 (2003).

[29] Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, art. 7 (Jan. 28, 2003) ("OECD Model Tax Convention"), n. 1.

[30] OECD Model Tax Convention, Articles 5, 7.

[31] *See* Libin & Gillis, *supra* note 39, at 204.

[32] Professor Richard Pomp, who testified as a tax policy expert on behalf of the taxpayer in *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), articulated "six principles of tax policy . . . as representing the values inherent in the commerce clause: desirability of a clear or "bright-line" test, consistency with settled expectations, reduction of litigation and promotion of interstate investment, non-discriminatory treatment of the service sector, avoidance of multiple taxation, and efficiency of administration." *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 at 15-16 (Oct. 23, 2003). Professor Pomp concluded that a physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.* at 16.

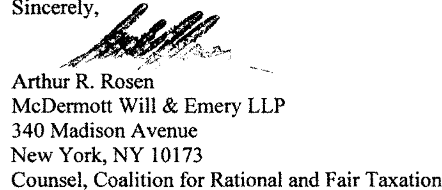
time-tested and valid Congressional policy. Physical presence is also an accepted standard for determining nexus.[33] And, a physical presence test for nexus is consistent with the established principle that a tax should not be imposed by a state unless that state provides meaningful benefits or protections to the taxpayer. BATSA provides simple and identifiable standards that will significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government.[34]

Moreover, our country's own history and the federal government's position in the context of international taxation provide sufficient reason to avoid an economic nexus standard. If a foreign country tried to tax the profits of U.S. companies simply because the U.S. firms exported goods to that country, the U.S. government and business community would be outraged. It is precisely for this reason that U.S. income tax treaties provide the nexus concept of "permanent establishment." A physical presence standard places an appropriate limit on states gaining taxation powers over out-of-state firms and conforms to common sense notions of fair play.

What the entire nexus issue boils down to is fairness. The bright-line physical presence nexus standard of BATSA provides the most fair and equitable standard. This is true primarily because businesses have a reasonable expectation of taxation only when they are the recipients of meaningful benefits and protections provided by the taxing jurisdiction. Additionally, businesses should only pay tax to those jurisdictions where they earn income.

At this time, there is no indication that the business activity tax nexus issue will be settled absent Congressional action. BATSA will not cause any meaningful dislocations in any state's revenue sources and will not encourage mass tax sheltering activities. Instead, its enactment will ensure that the U.S. business community, and thus the American economy, are not unduly burdened by unfair attempts at taxation without representation.

Sincerely,



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[33] *See, e.g., Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

[34] While it is unrealistic that BATSA will end all controversies concerning the state tax business activity tax nexus, any statute that adds nationwide clarification obviously reduces the amount of controversy and litigation by narrowing the areas of dispute. For example, in the nearly fifty years since its enactment, Public Law 86-272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense.

"Tax Reform: What it Means for State and Local Tax and Fiscal Policy"

Senate Finance Committee

April 25, 2012

Submitted by:

The Computing Technology Industry Association (CompTIA)
515 2nd Street, NE
Washington, DC 20001

Introduction.

Good afternoon, Chairman Baucus, Ranking Member Hatch, and distinguished members of the Committee. This testimony is submitted on behalf of the Computing Technology Industry Association (CompTIA) representing the information technology industry."

We want to thank Chairman Baucus and Members of this Committee for holding this important hearing concerning the effects of tax reform on state and local tax and fiscal policy. From the perspective of a small tech business, tax issues are measured in terms of cost and compliance burden; it does not matter whether the cost or burden is imposed by the federal government or a state or local government entity – the bottom line for these businesses is still "what is my cost" and "what is my compliance burden." Thus, as we move forward to consider the effects of tax reform on state and local fiscal and tax policy, we must be sure that federal tax reform does not merely shift costs and compliance burdens to state and local governments. Small businesses are already greatly impacted by state tax compliance burdens, and we believe that tax reform must bring certainty and simplification to a myriad of interstate tax issues.

About CompTIA.

CompTIA is the voice of the world's $3 trillion information technology industry. CompTIA is a non-profit trade association representing the information technology (IT) industry. CompTIA represents over 2,000 corporate members and 1,000 business partners. Our members are at the forefront of innovation and provide a critical backbone that supports broader commerce and job creation. These members include computer hardware manufacturers, software developers, technology distributors and IT specialists that help organizations integrate and use technology products and services. CompTIA is dedicated to serving its membership by advancing industry innovation and growth through its educational programs, market research, networking events, professional certifications, and public policy advocacy.

Based upon a recent CompTIA survey, we estimate that one in twelve (or about 12 million American adults) considers him or herself to be an IT worker. This is larger than the number of American adults classified by the Bureau of Labor Statistics (BLS) as employed in farming, mining, and construction combined. This is also close to the number of adults classified by BLS as working in manufacturing or transportation. CompTIA has concluded that the IT workforce is now one of the largest and most important parts of the American political community.

In view of the size and breadth of information technology in our national economy and the way in which state laws impact the industry, we submit testimony today that focuses on a matter that significantly impacts the industry: Interstate taxation.

The Issue: Policy Concerns Defined by Interstate Taxation Issues.

Although the term "Internet Taxation" has become a common term in tax policy debates and proposals, the Internet is merely the facilitating medium: The core issue is actually one of "*interstate taxation*," not "Internet taxation." While the tax in question might take on various forms, such as a sales tax, use tax or income tax, the common issue is: Which jurisdiction is permitted to tax a transaction having interstate components? This question becomes more blurred when the interstate transaction is performed over the Internet, as opposed to a physical party-to-party transaction across state borders. Currently, there are at least three types of legislation addressing Internet tax issues concerning interstate transactions that impact CompTIA members:

1. *Interstate sales of goods and services*: "Main Street Fairness Act" (H.R. 2701 and S. 1452), Marketplace Fairness Act (S. 1832) and Marketplace Equity Act (HR 3179)

2. *Interstate sales of digital products*: "Digital Goods and Services Tax Fairness Act of 2011" (H.R. 1860 and S. 971)

3. *Interstate business activities*: "Business Activity Tax Simplification Act of 2011" (H.R. 1439)

While both the interstate sales and digital products legislation emphasize Internet transactions, the real issues are (i) consistency/complexity in determining which jurisdiction can tax a transaction, and (ii) what party is responsible for collecting and/or paying the tax to the taxing jurisdiction. These same two issues also characterize the Business Activity Tax that applies to interstate transactions, whether or not accomplished via the Internet.

While the utility of the Internet clearly makes interstate transactions more common the core issue is: *Which government jurisdiction can tax a transaction, not whether the transaction was facilitated by the Internet.*

So, in discussing the application of these interstate (aka "Internet taxation") tax issues, the concerns to small businesses become:

a. The compliance burden and potential liability that could be imposed on businesses resulting from the uncertainty as to which state can tax a transaction; and

b. The compliance burden that might be imposed on businesses to pay, collect and/or remit sales taxes for all states/taxing jurisdictions.

1. Interstate Sales of Goods and Services.

Main Street Fairness Act (H.R. 2701 and S. 1452). This bill would grant states the authority to require any seller to collect and file sales tax returns on all interstate sales, provided that state is a full member of the *Streamlined Sales and Use Tax Agreement*. The intent of this legislation is to bring some uniformity to state sales tax requirements. Under current law established in a 1992 Supreme Court decision, a seller is only required to collect sales tax and file returns if that seller has a physical nexus to the state into which the sale is made. While this legislation does require the *Streamlined Sales and Use Tax Agreement* to include a small seller exemption, it defers to the participating states to determine the small seller threshold.

The Marketplace Fairness Act (S. 1832). This bill acts much like the Main Street Fairness Act, but would extend the authority to require out of state sellers to collect sales tax, provided that state is a full member of the *Streamlined Sales and Use Tax Agreement or* meets certain national thresholds and simplification requirements. Basically, the Marketplace Fairness Act does not lock states into adopting the *Streamlined Sales and Use Tax Agreement*, provided the state adopts comparable simplification. Thus, the Marketplace Fairness Act provides more flexibility for the states to make their own decisions concerning whether to join the *Streamlined Sales and Use Tax Agreement* or whether to adopt other provisions to come into compliance. This bill also contains a "small seller" exemption for businesses that have annual receipts of $500,000 or less from remote sales.

Marketplace Equity Act (HR 3179). This legislation is also similar to the Main Street Fairness Act, but would only extend the authority to require out of state sellers to collect sales tax, *after* the state implements a simplified system for administration of sales and use tax collection with respect to remote sellers. Unlike the Main Street Fairness Act and the Marketplace Fairness Act, this legislation does not invoke the Streamlined Sales and Use Tax Agreement. This bill also includes a "small seller" exemption that would exempt businesses with annual receipts of $1,000,000 or less from remote sales.

CompTIA Position. While each of the above bills requires a *"small seller"* exemption, the actual effect on *"small businesses"* is uncertain. Whether the exemption level is set at $500,000 or $1 million or more in annual revenues, the real issue for small businesses is whether they can absorb the added compliance costs of collecting and

remitting sales taxes under the new regime. Further, using an arbitrary "small seller" exemption dollar amount ($500,000 or $1,000,000 in annual revenues) ignores the reality that profit margins vary widely, depending upon the product or service being provided. A small business that has a 50% profit margin on revenue of $500,000 might be able to absorb the additional compliance costs, but a small business with a 5% profit margin on revenue of $500,000 would be disproportionately affected by this new cost. Clearly, mandating collection and reporting of sales taxes from multiple jurisdictions could cause some small businesses to abandon Internet sales.

Accordingly, this leaves only two options for small businesses: (i) oppose this legislation, or (ii) advocate for an exemption for *small businesses*, as opposed to small sellers. SBA has established and maintains detailed small business size standards that define a small business based on its industry. CompTIA asserts that adopting an exemption for small businesses based on the SBA size standards is much more logical than a static dollar sales amount applied across the board (which would have a disproportionate and uneven effect on small businesses).

The bottom line is that small businesses should not be exposed to new compliance costs and requirements. It is simply unfair for the states to be allowed to shift their tax collection burden onto the backs of small businesses.

2. Interstate Sales of Digital Products.

Whereas the interstate sales legislation applies to remote sales of goods or services, the "Digital Goods and Services Tax Fairness Act of 2011" (H.R. 1860 and S. 971) is restricted to the Internet sales of "digital goods or digital services." For example, a person who lives in Colorado flies to Illinois where that person downloads a digital program from a server located in California. The question is which jurisdiction has the authority to tax this purchase? Illinois would claim that the sale was made in Illinois, thus it has the right to charge a sales tax; California might assert that the purchase was made at the server in California giving it the right to collect the tax; and Colorado would claim that it has the right to tax its residents on purchases. H.R. 2011 simplifies these potential conflicts by limiting the collection of sales taxes on digital goods and services to the jurisdiction encompassing the buyer's tax address.

It is important to note that the Digital Goods and Services Tax Fairness Act does not authorize or prohibit the application of sales tax on the purchase of goods. It simply provides that the tax address of the buyer determines which state has the authority to tax the sale, which ensures that multiple states will not attempt to tax the same purchase. Thus, as with the interstate sales bills, the goal of the Digital Goods and Services Tax Fairness Act is to (i) provide consistency in determining which

jurisdiction can tax a transaction, and (ii) determine which party is responsible for collecting and/or paying over the tax to the taxing jurisdiction.

CompTIA Position. CompTIA supports this legislation. It would define a bright line to determine which state is permitted to tax a transaction; this would eliminate potential compliance costs for the provider and additional tax costs for the consumer that could result when two or more states claim competing authorities to tax a single transaction.

3. Interstate Business Activities.

The "Business Activity Tax Simplification Act of 2011" (H.R. 1439) would establish a physical presence nexus standard. This means that in order for a state to tax a business activity, that business must have a tangible connection to the state, such as an office or a sales force. This physical presence nexus requirement would apply to both Internet and non-Internet transactions.

In a 1992 decision (Quill Corp. v. North Dakota), the U.S. Supreme Court held that in order for a state to tax a non-resident individual or business, the individual or business must have a nexus to the taxing state, such as a real physical presence. Commonly, physical presence has been interpreted as having an office or place of business in the state, or employing workers that operate within the state. However, since the Quill decision was rendered, states have continuously sought to maintain or expand both their tax bases and collections, by chipping away at the physical nexus requirement.

The rationale for the physical nexus is that it is principally unfair for a state to require a business to collect sales and use taxes when that business has no physical presence in the taxing state. Yet, while physical nexus continues to be the law of the land with respect to sales and use tax collections, some states are now seeking to ignore this requirement for other forms of taxation – asserting that an "economic nexus" or "virtual nexus" is sufficient.

Using the economic nexus theory, some states have attempted to tax any transaction that touches the state, whether or not the parties are physically located in the state. For example, the "Amazon tax" laws passed by some states would require any non-resident seller to collect and remit sales tax if that seller acquires customers through a link on the website of an in-state business. This requirement applies even though the out-of-state business has no other presence in the state.

Again as with the interstate sales legislation and the digital products sales, the common thread is consistency and complexity in determining which jurisdiction has the authority to tax a transaction.

CompTIA position: CompTIA urges Congress to pass H.R. 1439, the "Business Activity Tax Simplification Act of 2011" which would establish consistent rules concerning *nexus* to (i) expand the federal prohibition against state taxation of interstate commerce to include taxation of out-of-state transactions involving all forms of property (such as intangible personal property and services) and (ii) prohibit state taxation of an out-of-state entity unless such entity has a physical presence in the taxing state. The issue is not whether a tax should be paid, but rather, to which jurisdiction a tax should be paid.

Conclusion.

Increasingly, small businesses are being burdened by the variety and amount of taxes that must be paid, as well as the costs of compliance. While CompTIA fully supports the tenet that all businesses should pay their rightful share of taxes, we believe this goal can and should be accomplished in the most orderly and least burdensome method.

For our small tech company members, the main issues are certainty and compliance costs. We believe that including a strong *small business* exemption in any Interstate sales tax legislation is essential. We also believe that providing certainty as to which state/jurisdiction can tax digital products and services, as well as other interstate business activities, is essential.

As Congress considers various aspects of tax reform, careful attention should be given so that federal tax reform does not merely shift costs and compliance burdens to state and local governments. Small businesses are already greatly impacted by state tax compliance burdens, and we believe that tax reform should and must work to bring certainty and simplification to a myriad of compliance-laden interstate tax issues.

Before the Senate Committee on Finance
United States Senate

Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Statement of the
Consumer Electronics Association (CEA)
April 25, 2012

Chairman Max Baucus, Ranking Member Orrin Hatch and Members of the Committee on Finance, on behalf of the Consumer Electronics Association (CEA), thank you for the opportunity to submit a written statement for today's hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy.

CEA is the preeminent trade association representing American innovators and entrepreneurs, both large and small, who are consumer technology companies. CEA's over 2,000 corporate members include manufacturers, Internet providers and retailers. Our members design, produce and sell products and provide services that enable millions upon millions of consumers every day to access the wonders of the Internet.

As the Committee considers the impact of tax reform on state and local governments, we urge consideration of legislation that would close a loophole currently harming traditional brick-and-mortar retail businesses while assisting the states in collecting approximately $23 billion in uncollected state sales taxes.

We believe that S. 1832, the Marketplace Fairness Act, a bipartisan bill introduced by a strong bi-partisan group of ten Senators, five Democrats and five Republicans led by Senators Durbin, Enzi, and Alexander, is an effective solution to rectify this inequity in today's marketplace.

First, let it be clear that the "Marketplace Fairness Act" **would not** enact new taxes. The legislation simply closes a loophole created by a decades-old Supreme Court ruling, issued in 1992 before the pervasiveness of Internet commerce. The ruling prohibits states from requiring remote sellers to collect sales and use taxes owed on purchases from out-of-state vendors.

This loophole has created an unfair price disadvantage for brick-and-mortar retail businesses and has placed an undue burden on consumers who do not realize they owe the sales tax if it is not collected by the seller. Additionally, in the year 2012, this loophole will cost state and local governments $23 billion in uncollected sales and use taxes.

We believe that the Marketplace Fairness Act represents the best thinking of all the stakeholders by providing a roadmap forward for states to collect sales taxes, simplify their sales tax statutes, and assist vendors with compliance, while providing for a robust small business exemption.

To put it simply, it is a common sense legislation that will help states with their own budget shortfalls without increasing the federal deficit, and close a decade old loophole that will level the playing field for all online retailers.

Tax Reform: What It Means for State and Local Tax and Fiscal Policy
April 25, 2012 10:00 am

Dale Copeland
1128 S. E. Greystone Avenue
Bartlesville, OK 74006

How might tax reform affect states and local municipalities? A simple change by Congress would have a zero net effect on the federal budget but would supply potentially millions, even billions, of dollars in revenue to states and cities that collect sales taxes. These taxes are already owed under state laws, but are avoided due to an uncorrected flaw in federal law.

The explosion of the Internet and on-line commerce has been a boon for the vast majority of citizens. It provides access to information and materials hitherto largely unavailable without considerable effort and expense. This is a good and desirable consequence in a field that could not have imagined the results and unintended consequences of electronic data transfer just a decade or two ago.

Some of those unintended consequences are now increasingly blossoming into evidence across the entire spectrum of government, business and tax law. No longer is commerce easily conducted nor regulated only within particular governmental boundaries. In turn, this creates gaps that savvy merchants find and exploit to their advantage. Unfortunately, these gaps also penalize merchants who "play by the rules" in providing product displays, product knowledge, after sale support, hiring local employees and the support of a myriad of local activities ranging from Little League, Scouts, Kiwanis, Rotary, etc. and service on local non-profit groups. Remote merchants provide none of this, even touting on their web sites that the main reason to buy from them is "NO SALES TAX!" Obviously, in my appliance sales and service repair business of more than 40 years in Bartlesville, OK, we are deeply involved in our community and work diligently in support of the community services listed above. But, even if we match the sales price of on-line merchants we are still always priced 8-1/2% too high since we will collect local sales taxes.

The increasingly common practice of "Showrooming" is another inequitable practice where shoppers use (I say 'Use' with the worst possible meaning) a local brick and mortar business to learn about and select a purchase, then they can go on-line to make their purchase and avoid sales taxes. The local merchant who employs staff, maintains a local presence with the attendant property taxes, and supports local ball teams, Scouts and other local causes is penalized twice. First when he pays to provide a service to shoppers with his inventory, knowledgeable staff and other costs, only to lose the sale to an out of state seller trading on a flaw in the tax codes. And second when the same customer expects after sale support of their purchase from the local merchant they beat out of a sale with their tax evasion. In the end even the customer suffers a loss when they are unable to get local support for their purchases and local government services decline along with declining revenue. How long can such an inequity continue?

I currently serve as the Ward 5 Councilman for the Bartlesville City Council and I see another consequence of these remote merchants' unfair competition as they are not only failing to collect sales taxes (sometimes called use taxes), but they provide no support of our community and its citizens. Municipalities in the state of Oklahoma rely almost totally on sales taxes for their operational budgets. It has been estimated that Oklahoma loses hundreds of millions of dollars each year in unpaid tax on sales from remote on-line merchant and catalog sales. Although present law requires Oklahoma citizens

to track and pay use taxes for out of state purchases when filing annual income tax reports, few do so and the sheer numbers prevent the state from effectively addressing this unlawful evasion of tax payments. Because of the current flaw in federal law our state is limited in its ability to recover these revenues at their source as they do with in-state merchants. In the final analysis this is a simple matter of fairness and the present system is inherently unfair.

Decades ago the argument was put forth that the Internet was in its infancy and thus somehow deserved the subsidy that this tax omission provided. But today, by any measure, the Internet is a massive force that can in no way be considered an infant. One may hear that it is "too hard" to collect sales tax for the multitude of taxing districts across the nation. But many remote merchants already do so. And these same merchants easily track thousands of suppliers, thousands of products and millions of customers in their data files. You likely have received contacts from them suggesting purchases based on past sales made months, even years ago, thus proving they have the ability to maintain, track and act with ease on the large amounts of data they utilize. The claims of "it's too hard" just don't ring true, but rather seem an excuse to maintain the unfair advantage they currently enjoy. A large number of states and the District of Columbia have worked together in support of the Streamlined Sales and Use Tax Agreement to further lessen any burden on remote merchants.

All that local merchants and municipalities ask is a level playing field.

The Supreme Court has ruled that the Congress can easily correct this inequity with a simple action like that provided in S. 1832 by Senator Durbin and others. This is not a new tax nor an "Internet tax," but simply allows the collection of taxes already owed by buyers under state law. It also provides exemptions for small or individual sales and provides a quite high dollar threshold to qualify. It is hard to imagine a multi-million dollar business complaining that the burden such a change makes would somehow render them unable to compete. Of course, the local merchant already operates under that burden and many brick and mortar merchants also conduct on-line sales. It is only fair to establish a level playing field for all merchants, regardless of their location.

I encourage you to restore fairness to all merchants while making it possible for local municipalities like Bartlesville, OK, to collect the taxes already owed under current state law. In this way free choice is retained and local brick and mortar merchants can fairly compete on a level playing field while continuing to support our communities. And city councils can continue providing our citizens the services they desire and deserve.

Respectfully submitted,

Dale W. Copeland
Owner, Copeland Appliance
Councilman, Ward 5, City of Bartlesville, OK

Tax Reform: What It Means for State and Local Tax and Fiscal Policy
United States Senate Committee on Finance
Wednesday, April 25, 2012, 10:00 AM
215 Dirksen Senate Office Building
Washington D.C.

Testimony provided by:
Mick Cornett
Mayor
City of Oklahoma City
200 N. Walker Ave., 3rd Floor
Oklahoma City, OK 73102

Thank you for the opportunity to testify before you and this Committee on the importance of passing S. 1832, The Marketplace Fairness Act, out of your committee.

The stability of the Federal, State and local budgets is a national concern. The long term commitments at each level of government often out strip even the most optimistic projections for future income. We hear time and time again that this emerging crisis has been long known, but that the structures for collecting taxes and committing future spending have not been altered to avert this course. This has most often been described by elected officials as "kicking the can down the road." We are facing a part of this crisis with our inability to collect sales tax for our citizen's internet sales purchases, but S. 1832 provides a solution and would end the twenty year history of kicking that can down the road.

Oklahoma City, like all cities in Oklahoma, relies heavily on sales tax to support operations. As technology advances and internet shopping becomes more prevalent, the City is losing an estimated $15-18 million annually to electronic vendors and internet sales. The Streamlined Sales and Use Tax project has been in process for several years and has resulted in a bill that would address this tax loophole.

This issue has been lingering for decades. In 1992, a Supreme Court ruling came out in the case *Quill Corporation v. North Dakota, 204 U.S. 298 (1992)* which stated that a retailer with no physical presence cannot be required to collect and remit sales taxes. This ruling was made when the internet was in its infancy. Today, online commerce has advanced to the extent that an estimated 10% of all purchases are made electronically, and this percentage continues to grow.

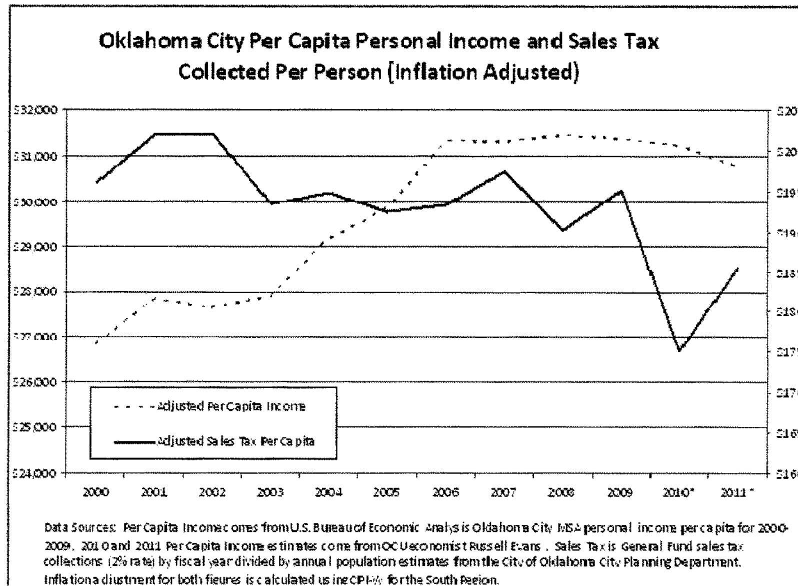
The *Quill* ruling offered a remedy to the unequal treatment of online and brick & mortar retailers. Congress could provide a single solution that would apply to retailers across the country. For the past 10 years, a group has been working to create a nationwide agreement to simplify the administration of sales taxes. They have created the Streamlined Sales and Use Tax Agreement (SSUTA) and to date, 24 states have signed on to the agreement. The provisions of the SSUTA require centralized collection and consistent definitions in each state to streamline administration of the taxes and simplify the collection process for vendors.

Online retailers have begun to collect and remit sales taxes in those states that are participating in the SSUTA. However, several online retailers have fought efforts to level the playing field and address the competitive disadvantage of brick and mortar businesses. The current situation creates an unfair advantage over our local businesses as their profit margin is lowered by the price differential created by electronic businesses who will not collect and remit state and local taxes.

It has been argued that this is a new tax and, therefore, any efforts to apply current sales tax laws to e-commerce should be opposed. This is not a new tax. It is the same tax applied to products that are purchased in a different way.

Arguments by opponents of sales taxes on electronically purchased goods primarily focus on the unfairness of taxing a retailer that does not have a physical presence in the state. This argument is completely off base since the retailer is not being taxed. The payer of the tax is the purchaser of the product – the resident of the local jurisdiction.

Another argument by opponents of taxes in general is that the government should cut back to live within the revenues it receives. Oklahoma City has done that repeatedly as our revenues have not grown in proportion to the service demands of our citizens. As the chart below shows, the City's inflation adjusted sales tax revenue has not kept pace with the inflation adjusted income of our citizens.



Data Sources: Per Capita Income comes from U.S. Bureau of Economic Analysis Oklahoma City MSA personal income per capita for 2000-2009. 2010 and 2011 Per Capita Income estimates come from OCU economist Russell Evans. Sales Tax is General Fund sales tax collections (2% rate) by fiscal year divided by annual population estimates from the City of Oklahoma City Planning Department. Inflation adjustment for both figures is calculated using CPI-U for the South Region.

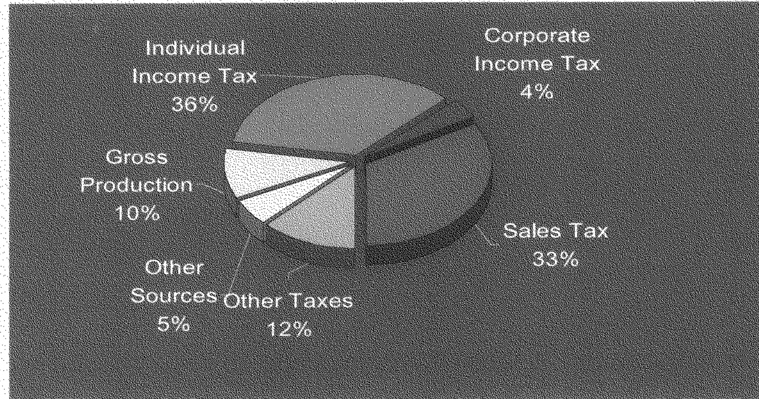
We already have laws in place that will allow for the collection of taxes on electronic sales from out of state vendors in the form of a use tax. However, there is no mechanism for the enforcement of a use tax. Out of state vendors have no compelling responsibility to provide the tax commission with information to enforce the tax and the taxpayer has only their own conscience to guide their remittance of the tax. While I am hesitant to draw a comparison to the Internal Revenue Service, in this case it is relevant. Imagine if the e-commerce segment of the economy was exempt from reporting their employees' earnings and collecting and remitting payroll taxes for them. The IRS would not be able to enforce Federal tax regulations and would only require employees to report whatever their consciences required as wages. Putting all of the issues aside about existing complexities and faults with Federal tax policy, imagine the chaos that would be created by this "loophole". This is the scenario facing cities and towns across America as retail sales are increasingly made online.

E-commerce offers tremendous advantages and opportunities to our residents, especially here in the middle of the country and in smaller population centers where retail opportunities are much more limited than they are on the east and west coasts. However, electronic retailers are provided a significant profit advantage by the "loophole" created by not having to collect sales taxes. This will, in time, cause the death of main street businesses in our country, especially in the areas where the population and income levels cannot support the diversity of retail opportunities offered on the coasts.

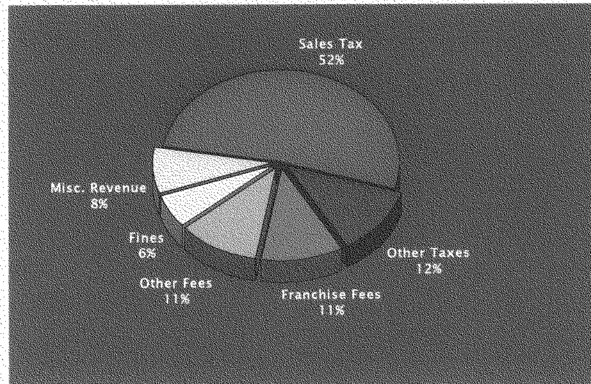
This consequence of the *Quill* Supreme Court decision was not anticipated or intended but it will be no less devastating to small and medium sized cities and their residents. In 1992, when the *Quill* ruling was made many people did not anticipate electronic commerce would become the segment of the economy that it is today. Online commerce has advanced to the extent that an estimated 10 percent of all purchases are made electronically and recent news reports indicated retail sales were up 16 percent this holiday season. Forrester Research reports that online sales are expected to grow 10 percent per year and exceed half of all U.S. retail sales by 2014. Online retailers charging the same prices as brick and mortar retailers can profit up to 10 percent from the unfair competitive advantage created by not collecting and remitting sales taxes.

The "Marketplace Fairness Act" would have a profound impact on the City of Oklahoma City. The graphs (below) show the revenue breakout for the State of Oklahoma and the City of Oklahoma City. More than half of Oklahoma City's general fund revenue is derived from sales tax. In terms of expenditures, nearly 66% of revenue is spent on public safety. Annually, $15-18 million from Oklahoma City's sales tax revenue translates into funding that could pay for 150 to 180 firefighters or police officers. Staffing in our public safety departments is a constant challenge because Oklahoma City covers 620 square miles and needs to provide service to our more densely populated urban areas in addition to developments or pockets of density that may be in outlying areas.

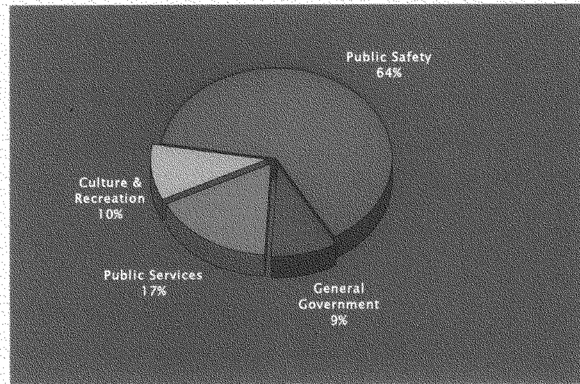
State of Oklahoma FY '12General Revenue Budget- **$5.24 Billion**



City of Oklahoma City FY '12 General Revenue Budget- **$364 Million**



City of Oklahoma City FY '12 General Expenditures by Function- $364 Million



In addition to my testimony today, the Oklahoma Municipal League is presenting testimony to this Committee endorsed by all the cities and towns in our state. It points out the importance the collection of sales tax is to the future stability of our state and our cities. Tax collection systems at the state and local level were developed in response to the negative impact of the loss of farms and businesses during the Depression because of the inability to pay property tax. When the sales tax was adopted in Oklahoma it was justified as a fair way to tax the commerce, or wealth, of the state, through the assessment of a tax on the citizens participating in that commerce. As an increasing number of our citizens' purchase on the internet with no sales tax being collected the historical foundation for Oklahoma's overall tax collection system is shaken.

In addition to being the primary tax source for the daily operation of our city including police and fire, our sales tax has provided the financing for the 19-year effort to revitalize economic opportunity in our city. A special one cent sales tax, dedicated to building public projects has totally altered our future. We have built or rebuilt all of our schools, our newly dammed and navigable river is now the US Olympic rowing site and we have over $3 billion in new private investment in the downtown area. We also have the OKC Thunder. Our citizens voted for this tax and established an oversight program to guide its implementation. These are the same citizens who increasingly use the internet for its convenience and scope and who will support the City's participation in the implementation of S. 1832.

The Supreme Court recognized the fairness and the need for the collection of local taxes on out-of-state sales. They just said that we needed to find a way to create a fair and non obtrusive way to collect these sales taxes. The states and cities and the vast majority of retailers in the country have done that through the careful drafting of S. 1832. We urge the Finance Committee to continue its tradition of simple and clear tax policy and to pass this bill out of committee.

April 25, 2012

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch,

As you prepare today to discuss the implications tax reform may have on state and local governments, the Council of Development Finance Agencies (CDFA) would like to bring to your attention the need to maximize the use of and improve the flexibility of Private Activity Bonds (PABs). PABs, in our decades of experience, are the single most effective tool in spurring state and local economic development, and are often the only available financing mechanism for small to mid-size manufacturers seeking to invest in their businesses and create jobs.

CDFA is a national association dedicated to the advancement of development finance concerns and interests. CDFA is comprised of the nation's leading and most knowledgeable members of the development finance community representing 300 public, private and non-profit development entities. Members are state, county and municipal development finance agencies and authorities that provide or otherwise support economic development financing programs, including tax-exempt and taxable bonds, credit enhancement programs, and direct debt and equity investments as well as a variety of non-governmental and private organizations ranging from regional and large investment banks to commercial finance companies to bond counsel, bond insurers, trustees, venture capital companies, rating agencies, and other organizations interested in development finance.

To assist in your tax reform deliberations, CDFA has developed a list of 7 greatly needed improvements. In no particular order, our proposed improvements are as follows:

1. Expand the scope of manufacturing facilities eligible for Industrial Development Bond (IDB) financing so that state and local bond issuers can help finance facilities that produce new and promising products and technologies, in addition to financing those facilities that manufacture more straight-forward, tangible items. This relatively small change would provide thousands of manufacturers with access to the capital markets.

2. Ensure manufacturing facilities financed with IDBs are not subject to illogical restrictions imposed by the out-of-date "functionally related and subordinate" rule.
3. Expand the 2% de minimis rule for IDBs so that financial institutions are permitted to purchase "new money" tax-exempt bonds issued in an aggregate amount not to exceed 2% of their adjusted bases of assets.
4. Increase the capital expenditure limitation for IDBs from $20 million to $40 million, or remove this limitation entirely so that IDB financings are current with the cost of business investments in today's economic climate.
5. Eliminate the restriction on the use of accelerated depreciation by companies using IDB financing.
6. Increase the maximum IDB bond size limitation from $10 million to $30 million and allow future limitation increases to be adjusted with inflation – again so that the tool is able to keep pace with the economy over time.
7. Expand and raise the small issuer limit for bank deductibility on IDBs and 501 (c)(3) bonds to $30 million from $10 million and allow the limit to be applied to the borrower instead of the conduit issuer.

To make the case for these proposed improvements, CDFA assembled a working group and polled its more-than-300 state, local and municipal member organizations. An astounding 100% of respondents agreed that Congress should make these much needed and overdue improvements to industrial development bonds. We are hopeful that this strong indicator will persuade the committee that common-sense, bi-partisan and low-cost reforms can be made to dramatically improve an already successful tool to create manufacturing jobs now.

CDFA, as always, is grateful for the opportunity to discuss these important development finance tools with the Committee and remains willing and able to serve as a resource during your time of deliberation and decision making.

Sincerely,

Toby Rittner
President & CEO
Council of Development Finance Agencies

Douglas L. Lindholm
President and Executive Director
(202) 484-5212
dlindholm@cost.org

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May 9, 2012

The Honorable Max Baucus
Chairman
United States Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Re: Hearing on "Tax Reform: What it Means for State and Local Tax and Fiscal Policy" (April 25, 2012)

Dear Chairman Baucus:

Thank you for the opportunity to submit this statement on behalf of the Council On State Taxation (COST) for the record of the April 25, 2012 hearing on "Tax Reform: What it Means for State and Local Tax and Fiscal Policy."

States are undeniably struggling with their budgets in the wake of the recession, and any federal tax reform initiative *must* consider how such reform will impact state tax systems. However, Congress must also consider the crushing administrative burden imposed by 50 state and countless local tax systems, and their impact on our nation's ability to remain competitive in a global economy.

Towards that end, COST has identified three areas in which we believe that Congress can and should provide meaningful simplification in the area of state taxation: nonresident withholding, business activity tax nexus, and remote sales tax collection.

About COST

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

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Daunting Compliance Issues for Travelling Employees

On February 3, 2012, the House Judiciary Committee reported out H.R. 1864, the Mobile Workforce State Income Tax Simplification Act of 2011. The problems H.R. 1864 seeks to address can be simply stated: every business day hundreds of thousands of employees across the country are sent by their employers to work in nonresident states. The vast majority of these trips are temporary in nature, whereby the employee conducts business in the nonresident state for a short period of time and then returns to his or her resident state.

Employees who travel outside of their home state for business purposes are subject to onerous administrative burdens because, in addition to filing federal and resident state income tax returns, they may also be legally required to file an income tax return in every other state into which they travel, *even if they are there for only one day*. So too, employers are extremely hard pressed to comply with the varying and disparate rules that relate to tax withholding on income earned by their employees while traveling. It is important to note that this tax compliance issue affects all employers: large and small businesses, charities and other non-profits, and even government agencies.

The problems created by these inconsistent state laws are universally acknowledged. There is also general agreement regarding the solution: create a simple, national threshold protecting employees who travel on temporary assignments to nonresident states. Indeed, the Multistate Tax Commission (MTC) on July 27, 2011, adopted a model state statute that is patterned after H.R. 1864. Unfortunately, model state legislation will never solve the problem. There is not a single example in the history of this country to suggest that voluntary adoption by all the states of a model statute to promote tax simplification is achievable. To this point, the MTC model statute has, to date, only been adopted in one state, and to our knowledge is not currently proposed in any other.

H.R. 1864 would provide a workable, national framework for the administration of, and compliance with, the states' withholding and nonresident income tax payment laws. Under H.R. 1864, an employee working in a nonresident state for thirty or fewer days would not pay personal income tax to the nonresident state, but rather would remain fully taxable in their resident state on all earnings. Employers would not be required to withhold taxes in the nonresident state for employees whose travel falls below the thirty day threshold. This uniform rule would greatly ease compliance for all employers and would provide much needed simplification for employees who travel as part of their work.

The mobility of our national workforce is one of our nation's greatest assets, and that flexibility is essential to our continued global competitiveness and ability to create jobs. That flexibility is hindered by the current hodgepodge of state laws. Employees who travel outside of their home states for temporary work periods, and their employers, will remain subject to today's onerous burdens without Congressional action. Thus, COST respectfully requests the Finance Committee's support for the speedy adoption of tax reform for travelling employees as embodied in H.R. 1864.

Uncertainty in "Nexus" Rules for Multistate Businesses

The House Judiciary Committee, on October 21, 2011, also reported out H.R. 1439, the Business Activity Tax Simplification Act of 2011. The first, and perhaps the most important determination a business must make with regard to its business activity (*e.g.,* income, franchise, privilege) taxes is whether the business is actually subject to tax in a particular state. That is, does the business have "nexus" with the state? Taxing businesses with only limited links to a jurisdiction has long been considered a burden on interstate commerce because of the high compliance costs associated with the taxation of such fleeting or nominal activity. It is not an exaggeration to note that since the first state business activity tax was imposed, taxpayers have never been certain as to what activities will be subject to taxation by a state or municipal jurisdiction.

The United States Supreme Court has offered some guidance and at least one bright line rule as to the requisite level of activities sufficient to subject a business to a state's tax without creating an impermissible burden on interstate commerce. In the Court's 1992 *Quill* decision, the Court retained its bright line rule that a state cannot impose a *sales tax* collection liability on a seller that does not have a physical presence in a state. However, the Court invited Congress to legislate in the area of nexus for state tax purposes, stating: "[O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but one that Congress has the ultimate power to resolve."

In absence of Congressional action following the Court's decision, states (and municipalities) have become increasingly aggressive in attempting to assert business activity tax jurisdiction over interstate commerce. These efforts to reach companies with minimal or no physical presence in a state have led to litigation in state courts with mixed results – not unexpected given the lack of clear guidance from either Congress or the United States Supreme Court. Conflicting state laws and court decisions create tremendous uncertainty and expense for taxpayers. Multistate businesses are deeply concerned both by this uncertainty and efforts by the states to impose tax on businesses that do not have physical presence in a state, thereby burdening interstate commerce and limiting cost-effective market options. Congress, accordingly, with plenary authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but also serves as the measure of last resort for the courts and for multistate companies on this issue.

COST believes that Congress should exercise its authority under the Commerce Clause to recognize physical presence as the nexus standard for business activity taxes. In doing so, Congress should include a *de minimis* threshold based on the temporary presence of employees, agents and property in the state. Congress should also modernize P.L. 86-272 by including services and intangibles in its scope, extending its application to all direct taxes, extending its coverage to activities subject to local taxes, and clarifying its definition of independent contractor.

Determination of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens – economic and administrative – only on businesses

that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means that businesses that are not physically present in a jurisdiction, and are therefore not receiving benefits or protections from the jurisdiction, should not be required to pay tax to that jurisdiction. Such a test also delineates a clear line to guide both businesses and the states (including their localities) on when a business can be subject to a state's tax.

As noted, in 1992 the Supreme Court invited Congress to legislate in the arena of nexus. Nearly twenty years later there has yet to be Congressional action on this matter. Once again, in 2012, Congress has the opportunity to properly construct a bright-line physical presence nexus standard that will promote fairness, eliminate uncertainty for both the business community and states, and significantly reduce the frequency and costs of litigation. Toward that end, COST respectfully requests the Finance Committee's support of the business activity tax nexus standards contained in H.R. 1439.

Sales Tax Complexity, Inequity

The existing state and local sales and use tax system creates burdensome and unnecessary complexity – this complexity imposes substantial costs on vendors, states, and consumers. A simplified sales tax system offers the potential to promote equitable and nondiscriminatory taxation, reduce tax rates for consumers, reduce administrative burdens for both business and the states, and improve compliance. Telecommunications transaction taxes should also be governed by such a simplified system.

Under the previously cited *Quill* decision, vendors with a physical presence in a state are required to collect and remit sales tax on taxable sales in a state. Vendors without a physical presence are not required to collect sales tax, but consumers are legally liable for use tax on taxable purchases when no sales tax is collected by the vendor. Congress has authority to remove this existing limitation and allow states to compel remote vendors to collect and remit sales tax, and, as noted above, has expressly been invited to do so by the U.S. Supreme Court. COST believes that collection authority *should* be provided to States that radically simplify their sales and use tax system.

Several pieces of legislation implicating this issue are currently pending in Congress, including the Main Street Fairness Act (S. 1452 / H.R. 2701), the Marketplace Equity Act of 2011 (H.R. 3179), and the Marketplace Fairness Act (S. 1832). In general, these proposals seek to grant sales tax collection authority to states that adopt sales tax simplification measures, such as the simplification embodied in the Streamlined Sales and Use Tax Agreement (which has been adopted in whole or in part by 24 states). COST urges Congress to find a reasonable balance between the goal of updating the current compliance framework for remote sales tax collection and the need to ease the administrative burdens imposed on interstate commerce by the current system.

Conclusion

In your Hearing Statement, you said: "As part of tax reform, we should ask how we can help states collect taxes owed and how we can encourage standard rules to protect taxpayers from multiple taxes and needless complexity." The three areas described above – nonresident withholding, business activity tax nexus, and remote sales taxation – are ripe for Congressional action to both protect taxpayers and aid in state tax administration through the adoption of fair, easily administered rules for travelling employees and multistate businesses. Specifically, COST urges the Finance Committee to approve measures consistent with those already approved in the House Judiciary Committee – H.R. 1864, the Mobile Workforce State Income Tax Simplification Act of 2011, and H.R. 1439, the Business Activity Tax Simplification Act of 2011 – and to approve legislation that would both ensure simplification of state and local sales taxes and the collection of such taxes by all sellers, regardless of the seller's location. COST stands ready to assist the Committee and answer any questions with respect to these and other areas of state and local taxation implicating interstate commerce.

Sincerely,

Douglas L. Lindholm

cc: COST Board of Directors

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THE CRISTOL GROUP

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4/18/2012

Honorable Max Baucus, Chairman
Honorable Orrin Hatch, Ranking Member
United States Senate
Committee on Finance
Attn.: Editorial and Document Section
Rm. SD-219
Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Re: April 25 Hearing: *Tax Reform: What it Means for State and Local Tax and Fiscal Policy*

Dear Honorable Chairman Baucus, Ranking Member Hatch and Members of the Committee:

I am the owner of The Cristol Group, Inc., a specialty food rep group headquartered here in Fort Lauderdale, Florida. We represent over 40 manufacturers of gourmet food products to the retail trade, mostly mom & pop retailers trying to stay in business in these hard times in Florida, Georgia, and Alabama where in the last six years we have lost over 200 small retail customers. . We have over a dozen Independent reps driving around their territories (paying $4.00 a gallon for gasoline) selling our lines which are shipped from many states directly to our customers. Our reps commissions are lower than ever, and another tax is all they need to go on unemployment. We are all just trying to hang on during the economic crisis. Of course any additional tax we would have to pay will have to come from the sales reps commissions as a deduction.

As a Florida resident and business owner for over a quarter century and a specialty food broker in Florida for 27 years, we desperately need your support of the Business Activity Tax Simplification Act (H.R. 1439). BATSA would prevent unlawful impediments to the free flow of commerce among the states by clarifying that no state may impose a business activity tax on any entity that lacks a physical presence in the taxing jurisdiction. The bill would provide a bright-line definition of physical presence. In addition, the Act would modernize current law (Pub. L. 86-272) relating to state authority to impose net income taxes on certain income derived from interstate commerce to cover services and intangible property. Thus, businesses would continue to pay business activity taxes to those jurisdictions that provide them with meaningful benefits and protections. We, as a company and the 12 Florida residents that work with us are hanging by a thread in this economic depressed business climate.

Some of our 1099 independent representatives cross over state lines into GA & AL and our company could be greatly impacted and would have to close and file Chapter 13 if we got hit with tax bills from these neighboring states. The BATSA Bill is our only protection from states who are trolling for tax dollars anywhere they can find them and is our only hope of keeping our business viable until this crisis blows over. It has to be enacted this year. It's taken too long already. Please don't "do nothing". Waiting will cause many of us to fail. Your constituents don't want Walmart to be the only store left to shop. Small businesses are the life blood of neighborhoods. These are the people we service. Their average orders are less than $500.00. Of that we get about 5 to 10%.

PLEASE do what you can to help us and small businesses like ours who have small sales but no physical presence in neighboring states stay viable in today's reality.

Thanks for your anticipated support of this important bill.

Thank you for your time and attention to this important matter.

Sincerely,

Sam Cristol, President
The Cristol Group, Inc.

**STATEMENT OF THE
DIRECT MARKETING ASSOCIATION
REGARDING THE
COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE
HEARING ON
TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY
APRIL 25, 2012**

JERRY CERASALE
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I. INTRODUCTION

The Direct Marketing Association (DMA) thanks Senator Baucus, Chairman, Senator Hatch, Ranking Member, and members of the Committee on Finance for this opportunity to present its views on the efforts of states to impose tax and tax collection obligations on retailers who are located outside of their states and who have no physical presence in that state. The states are asking Congress to grant them authority to conscript non-citizen businesses to become their tax collectors. These efforts are not federal tax reform—they are not state tax reform. They represent states seeking to impose a 1930's tax regime on 21st Century commerce rather than reforming their tax regimes and seeking Congressional help. In addition states are imposing business activity taxes upon companies with no presence, no employees, and no political voice in the state. These efforts combined are attempts to extend the taxing reach of states far beyond their borders. This undermines and regulates interstate commerce.

DMA is the leading global trade association of businesses and nonprofit organizations using and supporting direct marketing via channels including mail, telephone, direct TV, radio and the Internet. Founded in 1917, the DMA currently has over 2,000 member companies across the United States and 53 foreign countries.

DMA would like to discuss specifically state efforts to require remote (out-of-state) sellers to become unpaid tax collectors for states under the Streamlined Sales and Use Tax Agreement (SSUTA) and to pay business activity taxes.

II. STREAMLINED SALES AND USE TAX AGREEMENT

The U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), ruled that without specific authorization from Congress, states could not impose tax collection burdens upon remote sellers that have no "physical presence" as this would interfere with interstate commerce.

Moreover, if allowed by Congress, the myriad of state tax jurisdictions with resulting variance in rates, definitions, and audits would create a complex and administratively costly nationwide sales tax collection system. The costs of that collection are a tax on the out-of-state business. It is significant that these remote sellers' businesses do not receive police or fire protection from those states—they are not present in them. Their employees and their families do not receive educational or social services from those states—the businesses have no employees located in those states.

Governments, as well as businesses, face challenging financial decisions in these economic times. State legislatures have very difficult budget determinations and are looking at both cutting costs and increasing revenues. However, proponents of the SSUTA have cited grossly exaggerated revenue estimates of uncollected sales and use taxes due to remote sales. In particular, proponents have cited a 2000 University of Tennessee study that includes unbelievable estimates as to the amount of the uncollected sales tax. A revised Tennessee study lowered its initial estimate from $45 billion to $24 billion, even the revised estimates will not be realized.

It is important to note that the Tennessee study rests on a number of faulty assumptions and is not based on U.S. Government data. Further, the study's implication that states are "losing" a substantial portion of their sales tax revenues to electronic commerce is simply false. The vast majority of e-commerce transactions are not with consumers, but rather with businesses, and such business transactions almost always are subject to tax collection or direct payment of use taxes by the purchaser.

In contrast, the independent firm, Forrester Research, has estimated that the loss of tax revenue due to state residents not paying use taxes for remote sales is $3 billion nationwide—a fraction of the $24 billion estimated in the revised Tennessee study. A 2007 DMA-commissioned study, based on U.S. Commerce Department data, estimates that in 2006 uncollected sales tax nationally totaled $4.2 billion. There is no $24 billion pot of gold.

In light of the *Quill* decision, the states began a project to simplify the sales tax regimes that a remote seller would face if required to become the foreign state's tax collector. The SSUTA goal was to remove that complexity and create a 21st century, Internet-friendly tax regime to encourage economic growth throughout the national marketplace. However, the SSUTA has failed to either remove complexity or create that 21st century tax policy standard. To be blunt, the SSUTA is a document drafted by tax administrators, and, as might be expected, it has resulted in little in the way of tax simplification.

Specifically, the SSUTA:

- Has not reduced the number of sales tax jurisdictions in the Nation, which currently number over 9,000;
- Has not reduced the number of state and local sales tax rates;
- Has not reduced the number of audits to which an interstate seller would be subject (each state revenue department would still conduct its own independent audit);

- Has not established a long-promised uniform vendor compensation to cover the substantial cost of tax collection; and
- Has not established a single remittance procedure.

Moreover, the Governing Board of SSUTA has granted exceptions to its feeble simplification initiatives to win approval of the states. Recently, the Board granted an exception from the SSUTA-defined rule for Massachusetts when calculating the sales tax on articles of clothing over $100. SSUTA will continue to grant exceptions that will increase the complexity of sales tax collection. States are enacting sales tax holidays—some for all purchases under a capped price; others for specific products (such as hurricane preparedness) on a specific date. Those actions, while important for the state and its citizens, further complicate a nationwide sales tax collection regime.

As you can see, tax collection has not been simplified since the inception of SSUTA. In fact, SSUTA is "streamlined" in name only.

To better appreciate the failings of the SSUTA, it is instructive to consider its history. The Streamlined Sales Tax Project was launched in 2000 on the heels of two earlier joint government/industry initiatives: the National Tax Association (NTA) Communications and Electronic Commerce Tax Project, and the Congressionally-established Advisory Commission on Electronic Commerce. Both projects had concluded that the existing state sales tax system was one of daunting complexity, and that true simplification would require sweeping reforms.

Perhaps most emblematic of the SSUTA's failure to achieve genuine sales tax reform was the early demise of the single-most important step toward simplification: the adoption of a single sales tax rate per state for all commerce (both over-the-counter sales and interstate sales). Had the SSUTA adopted this so-called "one rate per state" proposal, this single act could have eliminated the problem of merchant compliance with thousands of local tax jurisdictions with different tax rates.

To put this "one rate per state" issue in perspective, the United States is the only economically developed country in the world with a system of sub-state transaction taxes, not only for counties and municipalities, but also for school districts, transportation districts, sanitation districts, sports arena districts, and other local jurisdictions. In light of this wildly complex system, the adoption of the "one rate per state" standard was the *unanimous* recommendation of the NTA's E-Commerce Project (which included delegates of the National Conference of State Legislatures, National Governors Association, and US Conference of Mayors) and was in the majority report recommendation of the Congressional Advisory Commission.

Those failings increase the burden on out-of-state sellers. Being subject to 45 separate state audits requires a tax department. Those businesses would be required to have multiple state registrations and multiple remittance procedures. The cost stemming from tax collection would be passed to consumers, constituting an anti-stimulus at a time when our nation is working to stimulate the economy. Moreover, remote sellers with locations only in states that do not impose sales taxes, and that, in turn, have no process in place to collect any sales taxes, would be

required to create an entirely new tax department within their company and establish entirely new accounting and ordering protocols. Those remote sellers would face even greater burdens.

Any discussion of tax reform concerning non-citizen companies becoming tax collectors for states, should require tax reform in terms of simplification of state sales tax regimes. Only after that reform should Congress consider granting additional interstate taxing authority to the states with the *proviso* that the tax regime simplification must remain in place.

III. Business Activity Taxes

Broad imposition of business franchise, corporation net income, and gross receipts taxes (commonly called Business Activity Taxes) on small and mid-sized out-of-state remote direct marketers would constitute a tremendous new tax compliance burden. Currently, there are at least 3,300 separate state and local business activity taxes imposed by state and local governments and over 12,600 jurisdictions have the authority to collect such a tax. Just as the Supreme Court found in its *Quill* decision, precisely the same burdens created if sales and use tax obligations were imposed by the nation's over 9,000 sales and use tax jurisdictions would also result from allowing the thousands of state and local jurisdictions that have the authority to impose a business activity tax to extend their taxing authority across state borders to businesses with no stores, offices, factories or employees within their territories.

Despite assertions that business activity taxes do not appear to cause the same degree of compliance burdens as sales and use tax collection, the reality is that compliance with state income taxes and gross receipts taxes is extremely complicated and varies greatly from state to state. Forty-five states, along with the District of Columbia, impose such a tax. States differ tremendously in how income is allocated and apportioned, in how the tax base is defined, in what tax rates apply and in a host of other issues.

States also have varying rules regarding reporting and filing procedures, including which corporations must file a return, whether related entities should file together or separately, what due dates apply for filing and remitting taxes, and whether federal extensions are accepted. Roughly half the states allow combined reporting, whereas and other half require or allow separate reporting by each entity within an affiliated group. Among the states that follow combined reporting of unitary businesses, there are dramatic differences regarding the level of combination.

Another cause of considerable complexity is the fact that the states have different rules for allocating and apportioning a multi-state corporation's income among the states in which it does business. Most states use a three-factor formula (i.e., sales, property and payroll) to apportion business income. Some states weigh all factors equally, other states double-weight the sales factor, and some states place even more emphasis on sales. Furthermore, while sales are typically assigned to a particular state based on a destination test, some states use a "throwback rule" that reassigns sales to the state of origin if the corporation is not taxable in the destination state. States also differ in their definitions of the tax base, with varying stances on what items of income and deduction are included in taxable income. States have different depreciation rules, rules for deduction of net operating losses, and the list goes on.

Large companies with accounting staffs and outside consultants may be able to navigate successfully through the labyrinth of state income tax compliance, but smaller companies do not have the resources to meet these compliance obligations. Further, the differing apportionment standards among states place a business, especially a smaller company, at risk of duplicative over-taxation. This risk is increased by the fact that there is no centralized resource to which businesses can turn in determining, let alone meeting, their obligations.

Moreover, the prospect of challenging an incorrect assessment in a remote jurisdiction is daunting. For example, a small Montana business sells gourmet food products over the Internet. With a good website and a great set of recipes, there is no limit to the national – or even international – markets this start-up business could reach. However, if one of New Mexico's 100-plus taxing municipalities issued an assessment against the company for a local gross receipts tax based on sales made to its citizens, and the Montana business believed the measure of taxes was in error and challenges the assessment, it would have to hire local counsel familiar with local tax law, proceeding first through the administrative protest and, if unsuccessful, then through the judicial process. Furthermore, in many states, the business must pay the tax before it can challenge the assessment in state court; only then is it permitted to sue for a refund. Such a procedure would be inordinately expensive for a small retailer, which would be left with little choice but to pay the tax and forget its objections. Faced with potentially hundreds of such practically incontestable assessments, the small Montana food company could fall victim to "death by a thousand cuts." The detrimental impact on small business cannot be overstated.

IV. Conclusion

The bright-line physical presence test in *Quill* should remain for collection of sales and use taxes without significant simplification reform of state sales tax regimes. The burden of each on interstate commerce is large, and this is a time when our economy can ill afford such a burden.

Congress should not grant the states authority to expand business activity taxes or forced sales and use tax collection beyond their borders. Federalism does not work efficiently— or fairly— when a legislature attempts to export its tax laws across state borders. A system in which 50 state governments, and thousands of localities, impose their myriad sales and use tax regimes on businesses in each of the other 49 states would be chaotic, both as a matter of tax administration and business compliance. The end result of expanded nexus will be nothing less than a crazy quilt of non-uniform tax laws and compliance obligations that will further stagnate the consumer sector of the economy and aggravate an already grossly inefficient system of multi-state tax administration. The patchwork quilt of business activity taxes, rules, definitions, reporting, etc. will chill the one growing engine of our economy, Internet commerce, by burdening new start-up companies before they have the opportunity to grow.

DMA urges Congress both to uphold the physical nexus standard of *Quill* rather than extending taxing authority of states to include the collection of sales and use tax beyond their borders without significant simplification reform by the states, and to impose the *Quill* standard to states applying business activity taxes to remote sellers.

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Written Statement of The Dow Chemical Company
Before the United States Senate Committee on Finance
Hearing on "*Tax Reform: What it Means for State and Local Tax and Fiscal Policy*"
April 25, 2012

The Dow Chemical Company applauds the Senate Finance Committee for its attention to state tax issues. In particular, we would like to direct the Committee's attention to the issue of business activity tax nexus. We at Dow strongly support the Business Activity Tax Simplification Act ("BATSA"), H.R. 1439, and respectfully urge the Congress to enact that bill into law this year.

The income of multi-state businesses, like ours, traditionally has been subject to state income and similar taxes only in those jurisdictions in which the business has a physical presence, such as employees, an office or inventory. More recently, however, some states have asserted the right to assess business activity taxes on non-resident companies that have merely an economic presence (*i.e.*, sales or royalties), but no physical presence, in the taxing jurisdiction. State courts that have heard cases challenging such assessments have split on whether or not such taxes violate the U.S. Constitution's Commerce Clause. The U.S. Supreme Court has declined to hear the issue, indicating that Congress is better suited to resolve the matter.

The business community needs Congress to step in now with a legislative solution to the problem. By enacting BATSA, Congress will satisfy its constitutional responsibility to ensure that interstate commerce is not burdened by state overreaching, without interfering with the ability of the states to tax companies that are properly subject to their jurisdiction. Specifically, BATSA would clarify that physical presence is required for state assessments of income and similar taxes on non-resident companies. It would also provide a clear and consistent definition of physical presence.

Enactment of BATSA would promote fairness by ensuring that businesses that receive the benefits and protections provided by state and local governments pay their fair share for those services. The bill also would provide taxpayers and states with legal certainty regarding where a business owes income taxes, resulting in lower compliance costs, less litigation and a stable business climate in which tax considerations do not hinder business decisions. Finally, the bill would result in greater conformity for business activity taxes at the state and local level with the "permanent establishment" standard that is used by the U.S. in its treaties with foreign countries.

Without passage of BATSA, taxpayers will continue to face insufficient clarity on whether there is an obligation to file an income tax return. For example, some states today believe that an author that receives royalties from the sale of books is subject to tax in every state where the book is sold. Conceptually this doesn't sound very difficult, but imagine being that author and trying to file your tax returns without knowing the states of sale. Now imagine a corporation like Dow that owns thousands of patents, some of which it chooses to license to independent licensees. Some of these patents may be related to a specific product while others may be related to the manufacturing processes used to make various products. In many instances, the royalties for the use of a patent is based upon sales for administrative ease. In the case of a patent related to a manufacturing process, some states may argue that the patent was used in the state where the manufacturing took place and the royalty income is taxable in that state. Other states may argue that the same royalty is taxable in the state(s) where the product using the licensed patent was sold. To further complicate the picture, making these decisions often requires the review of each license agreement. As you can imagine, this is very difficult to determine and creates great uncertainty to businesses trying to determine in which states they are subject to tax. In addition to the uncertainty created, this creates the potential for the same royalty to be taxed by multiple states (both the state of manufacture and the state where the end product is sold) despite the fact that the owner of the patent has no connection to either state. This uncertainty creates unnecessary costs and administrative burdens.

We hope this uncertainty can be resolved through passage of BATSA.

Thank you for the opportunity to comment on this matter.

About Dow: Dow combines the power of science and technology to passionately innovate what is essential to human progress. The Company connects chemistry and innovation with the principles of sustainability to help address many of the world's most challenging problems such as the need for clean water, renewable energy generation and conservation, and increasing agricultural productivity. Dow's diversified industry-leading portfolio of specialty chemical, advanced materials, agrosciences and plastics businesses delivers a broad range of technology-based products and solutions to customers in approximately 160 countries and in high growth sectors such as electronics, water, energy, coatings and agriculture. In 2011, Dow had annual sales of $60 billion and employed approximately 25,000 people in the United States. The Company's more than 5,000 products are manufactured at 197 sites in 36 countries across the globe. More information about Dow can be found at www.dow.com.

Testimony on Behalf of the Download Fairness Coalition

Committee on Finance

Tax Reform: What it Means for State and Local Tax and Fiscal Policy

April 25, 20112

Download Fairness Coalition

455 Mass. Ave., NW

12th Floor

Washington, D.C. 20001

Testimony on Behalf of the Download Fairness Coalition

Chairman Baucus, Ranking Member Hatch, and members of the Committee, on behalf of the Download Fairness Coalition, we welcome the opportunity to present testimony in support of S. 971, the Digital Goods and Services Tax Fairness Act authored by members of the Committee, Senators Wyden and Thune, and cosponsored by Senator Snowe. In addition, Senator McCain is a cosponsor of the bill.

Our coalition, including 29 companies and organizations, banded together last year to drive a solution to a very real problem, and one that Congress must address. Without action by Congress, the digitial market – downloadable songs, aps, books, and movies – could be subject to unfair and duplicative taxes that will cost consumers more money and hamstring growth of a major sector within our economy. The Download Fairness Coalition is a diverse group of consumers and organizations that are committed to ensuring a framework is enacted to guide the taxation of digital goods and services before consumers, American businesses, and states are unfairly impacted.

Each of you and your staff is well versed in the use of electronic devices. Our society has become extremely comfortable with the notion of hitting buttons and having things delivered to us. Our focus is purely on the digital world of bits flying through the air and moving those bits to the digital platforms we carry around each day, including our cell phones, our kindles, our Ipads, and similar devices.

A recent Pew report entitled, *Digital Differences,* April 13, 2012, provides a number of important statistics for you to consider.

1. 80% of Americans use the internet;
2. 88% of Americans have a cell phone, 57% have a laptop, 19% own an e-reader, and 19% have a tablet, and the trend of e-book and tablet purchases continues to climb, from a standing start to an increase of 9% from August 2011 to January 2012; and,
3. 71% of adult internet users buy products on-line.

All of this data suggests that Americans are utilizing these platforms more and more, driving the new digital economy. The sale of digital goods, such as downloadable software, music, movies, games, and books, continues to increase. In 2010, for example, U.S. online retailers sold 1.17 billion digital music tracks totaling $1.5 billion in revenue. Similarly, e-book sales in the United States reached $1 billion and are expected to almost triple by 2015. Amazon carries almost one million titles available for download on its Kindle e-book reader and has found that when it carries both a physical and digital edition of a book, it sells six Kindle books for every ten physical books. On mobile devices, U.S. consumers downloaded almost 1.6 billion free and paid apps in 2010, generating approximately $1.6 billion in paid app revenue. Apple announced recently it had delivered its 25th billionth app. Android, late last year announced it delivered over 10 billion apps.

The appetite for digital goods is growing at a phenomenal rate; however, state tax laws have not kept pace with the new digital economy. This is the problem that needs to be addressed, and only Congress can solve this problem.

In the digital world, we do not walk into a store in downtown Bozeman, or Salt Lake City, and buy a product. We could be anywhere, at the top of Big Sky, Solitutde, Mt. Bachelor or viewing Mr. Rushmore, and search our electronic device for a song or a movie and hit "accept." The product is delivered immediately.

What state has the right to impose a sales tax on that transaction? The spot where you hit the button, the location of where the server is for the company selling the song, or the state where you reside? It is a critical question and without an answer, the shape of digital commerce remains in limbo, for both the consumers and those obligated to collect and remit the taxes.

S. 971 would specifically establish a framework for the states to follow, should they decide to tax digital goods. The simplest way to describe the framework is that a consumer would be taxed in his or her home state.

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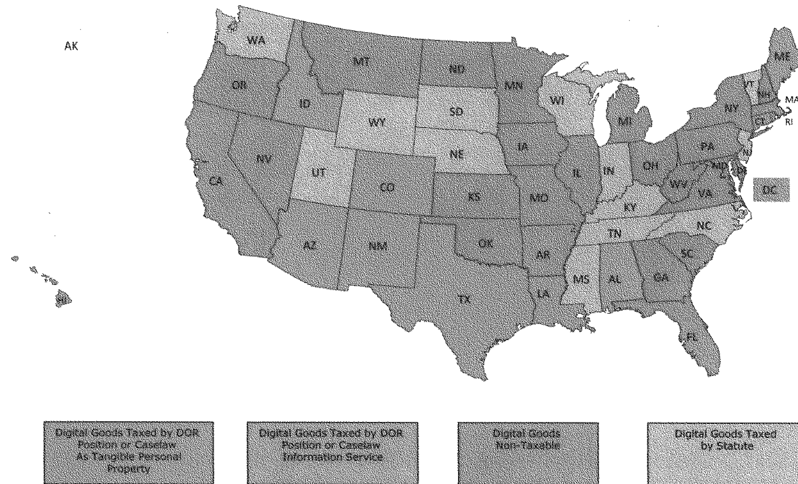
1. The framework is based on one that Congress enacted some 10 years ago with respect to mobile phones through the Mobile Telecommunications Sourcing Act, P.L. 106-252, which sourced a purchase – for the purpose of taxation, to the consumer's address. In the case of digital goods, only the the state where the consumer's address is located would have the ability to tax a purchase.
2. The right of each state is preserved, enabling each to make its own determination regarding which goods and services they want to tax.
3. Consumers residing in that state (or at least those old enough to vote) would have a say with their state government on those decisions.
4. That same consumer would not be subject to another state's tax, imposing a duplicative tax, or an unfair tax on the transaction.

As shown in Figure 1, more than 20 states currently collect taxes on digital goods. These states have created these taxes either by statute or administrative changes to the tax code. Of these, 13 states have enacted sales tax statutes specifically to tax digital goods or services, including: Indiana, Kentucky, Mississippi, Nebraska, New Jersey, North Carolina, South Dakota, Tennessee, Utah, Vermont, Washington, Wisconsin, and Wyoming. A number of other states have or are currently exploring the possibility of passing a tax on digital goods and services. States should have the ability to make their own revenue decisions, but as more states choose to tax these products, there is inevidably more confusion around which state can tax these purchases inviting more risk to both the consumer and the provider. It is, therefore, timely to pass this legislation now, before the risk of a potential problem has real impacts on consumers and our economy.

Figure 1:

Digital Goods – Legislative Activity

Taxability as of 2012 under generally applied sales taxes



Before a House Judiciary Committee hearing last May, Rob Atkinson, President of the Information Technology and Innovation Foundation noted that "by creating a fairer and more consistent tax system for digital goods, this legislation will help promote and sustain our growing digital economy."

We urge you to enact S. 971.

eBay Inc.
1250 Eye Street, N.W. Suite 1200
Washington, DC 20005
www.ebay.com

May 8, 2012

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
511 Hart Office Building Washington, DC 20510

The Honorable Orrin G. Hatch
Ranking Member
Committee on Finance
United States Senate
104 Hart Office Building Washington, DC 20510

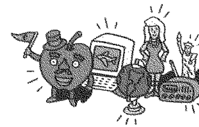
Re: April 25, 2012, Hearing Entitled: *Tax Reform: What It Means for State and Local Tax and Fiscal Policy*

Dear Chairman Baucus and Ranking Member Hatch:

Thank you for convening a hearing on federal tax reform and its impact on state and local governments. The hearing is very timely, and we appreciate the Committee's leadership on state taxation issues related to tax reform.

I would like to address the issue of Internet sales taxes, which could negatively impact small business retailers in every state using the Internet to reach customers across America and around the world. Over the past 16 years, eBay Inc. has been a platform that has encouraged small business growth and development and as a small business platform, we have experienced firsthand the challenges that small retailers face in the current retail environment. With this experience in mind, I would like to discuss three growing concerns related to the Internet sales tax debate and small business protection:

- **Big Retail v. Small Retail:** Mega-billion dollar retailers are dominating online retail, just as they have Main Street retail. Even under current sales tax law, small online retailers have lost 11% of their share of the eCommerce market in just two years. What would happen when they would be forced to collect and remit in over 9,500 tax jurisdictions?



- **Fairness v. Sameness:** Many have claimed that "fairness" means all retailers using the Internet should be held to the same remote sales tax standard. If fairness is considered sameness then small businesses should be receiving the same shipping costs and sweetheart tax deals that mega-billion dollar retailers receive.

- **Misleading Data:** There are those that believe small businesses should not be protected from new sales tax burdens. In an effort to sway policymakers, Amazon has commissioned a study entitled, *Online Retail Sellers and Sales Volume Thresholds,* that implies a majority of small businesses would be protected by the threshold in S. 1832. The study distorts retailer data by including millions of consumers who occasionally sell on the Internet in its data.

The Internet and Small Business Growth

eBay Inc. connects millions of buyers and sellers across the globe everyday through the eBay platform, which is the world's largest online marketplace and through PayPal, which enables individuals and businesses to securely, easily and quickly send and receive online payments. We also reach millions of consumers through specialized marketplaces such as StubHub, the world's largest ticket marketplace; and eBay Classifieds sites, which together are available in more than 1,000 cities around the world.

Among those that use the eBay platform are hundreds of thousands of U.S. small businesses and entrepreneurs who are located in every state and congressional district across the country. The Internet and the eBay marketplace provide these small businesses and entrepreneurs with relatively low-cost access to potential buyers far outside the limits of their traditional geographic footprint. eBay cares about how proposals to expand remote sales tax collection would impact these small business retailers and entrepreneurs because they have always been at the heart of the eBay business model. Our success is tied directly to their success.

Technology and the Internet are now central to almost every retail business model. This is true for businesses of all sizes, including small businesses. By opening up new markets, the Internet empowers particularly small businesses to grow outside of traditionally disadvantaged communities and compete nationwide. eBay and the Internet also open international markets to small business retailers in ways unimaginable just fifteen years ago,

The debate about remote sales tax policy on the Internet stretches back over a decade. While much of the rhetoric fueling the call for increased remote sales tax collection has stood still, the world of retail has changed. The very idea that this debate is about "The Internet" v. "Stores" is a false paradigm. All sustainable 21st Century retail business models, both large and small, use the Internet and other technology tools. All 21st Century retail business models have some physical facilities, whether stores, management offices, warehouses or distribution centers. The debate has really come down to "Big Retail" v. "Small Retail" and whether or not it is smart public policy to treat a small business the same as a mega-billion dollar retailer.

Big Retail v. Small Retail

At the heart of the story has been the expanding dominance of giant retailers at the expense of small business. Over the past 30 years, giants have grown more dominant in retail, while small independent retailers have been pushed to the edges. To illustrate, big-box retailers accounted for 42% of total retail sales in 1987. As of July 2010, their market share had jumped to 87%.[1] In addition, retail giants make up 18 of the Top 25 retail websites today.

These same retail giants are trying to use a bill named the Main Street Fairness Act (S. 1832) to disadvantage small businesses and require them to have the same tax burden, even though they do not have the physical presence or other benefits that larger retailers enjoy. The giant billion-dollar retailers with their national stores or distribution networks can offer key services like in-store pick up, same day delivery, free or significantly lower-cost shipping, and in-store returns of items bought online. Consumers value those features, and the biggest of the big are better positioned to offer those services.

In online retail, being giant has its advantages just as it does in traditional brick and mortar retail and physical presence brings real world benefits to retailers Small retailers tend to have very limited physical presence and therefore do not fully enjoy the advantages that larger retailers possess. Today, the retail benefits of physical presence come with a tax cost, and retail businesses have understood that rule for years.

Even though giant retailers have a larger sales tax burden due to their larger physical presence, the benefits have outweighed the tax cost. In fact, in the current landscape, large "Brick and Click" retailers and the largest online retailer Amazon have experienced healthy growth. On the other hand, the share of online sales by retailers with less than $20 million in sales is falling. And not surprisingly, the giant retailers who are now dominating the Internet marketplace are lined up, united in proposing a change in remote sales tax law that will harm the smaller retailers who do not have national physical presence. While small business retailers are active online and are adopting technology, they do not enjoy any particular advantage and face significant competition from large retailers who are also adopting the full range of technologies. Small business retailers using the Internet face meaningful threats and we are concerned about what the landscape could look like if they are forced to collect and remit sales taxes in over 9,500 tax jurisdictions when their customers would not enjoy the benefits of local presence that the largest retailers can pair with the tax costs today.

Market share data helps cut through the rhetoric and illustrates that small business retailers face meaningful challenges today without a new tax burden being placed on them by the US Congress. In short, if small business retailers using the Internet were gaining unfair advantages from current remote sales tax laws, one would expect that their share of Internet sales would be growing. As you can see from the chart below, it is not the case. Just as importantly, the idea that small business retailers on the Internet are a threat to the survival of small business store fronts is ridiculous. The threat to small independent retailers is coming from giant multi-billion dollar competitors online and offline, which has been the case for nearly half a century.

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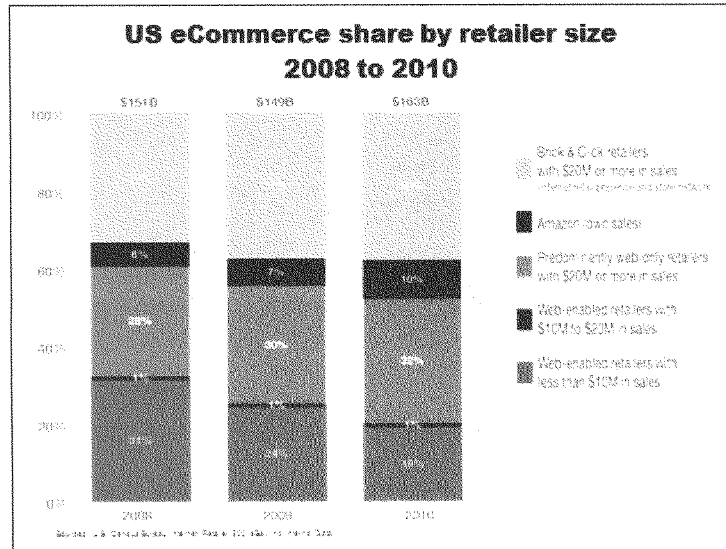
[1] ConsumerReports.org. (July 2010). *America's Top Stores: 30,000 Readers Reveal the Best Places to Shop for Practically Anything.* Consumer Reports



<u>**Fairness v. Sameness**</u>

You hear a lot about fairness in this debate. Some have claimed that a "level playing field" means all retailers using the Internet should be held to the same remote sales tax standard. However, sameness is not fairness, and the playing field is already unlevel. Small business retailers have proportionally higher costs of doing business, including providing employee benefits. And one must especially consider the costs of shipping when discussing e-commerce. Shipping prices, as with other costs, are directly related to sales volumes and how close the retailer is to the customer.

There are also many direct tax benefits enjoyed by the largest retailers that never flow down to their small business competitors. These include state and local property tax breaks and sales tax exclusions. Do those who want a "level playing field" demand that all small business retailers get the same tax credits, the same sales tax exclusions and the same shipping rates? If and when they do, we will be the first to endorse changing *Quill* and lifting the prohibition against remote sales tax collection and remittance.

There has also been a lot of discussion about how the current remote sales tax structure is unfair for state and local governments that are hemorrhaging money in this current economic environment. Although eBay is sympathetic to states' budget woes, recent reports have indicated that with the rise of the "Brick & Click" retailers who are now collecting and remitting in most tax jurisdictions, the amount of uncollected revenue has actually been dramatically

reduced. In fact, according to a study by economists Jeffrey Eisenach and Robert Litan, uncollected revenues (from firms with more than $5 million in remote sales) will average approximately $2.67 billion over the 2008-2012 period, or about two tenths of one percent of total state and local tax revenues.[2] Is it really worth changing the sales tax law in a way that would disadvantage small business retailers using the Internet for about two tenths of one percent of total state and local tax revenues?

In addition, in a recent report by the National Governors Association and the National Association of State Budget Officers, state revenues are starting to improve and 38 states reported that they had higher general fund spending in fiscal 2011 compared to fiscal.[3] States are rebounding from the recession, and although this is a slow process, it is our concern that placing additional burdens on small business retailers using the Internet that operate in every state across the country is not a way to promote the growth of a larger tax base.

Current law regarding remote state sales tax authority is not perfect, and there have been problems. A few large online retailers have not operated in the spirit of the law, failing to collect sales taxes where they have physical presence, which has in turn aggravated this issue and brought it to a breaking point. However, their smaller competitors are and do collect and remit sales taxes for purchases made both online and offline. In addition, states have chosen not to enforce their consumer Use Tax laws and have instead opted for an approach that would burden out of state businesses, which although politically expedient will not encourage small businesses growth and development nationally. These are real problems with the current system.

But current remote sales tax policies for small business retailers using the Internet are a positive aspect of the current system. Protecting real small businesses from blanket remote sales tax collection is beneficial for retail competition and economic growth, and should be retained in any new remote sales tax regime. And the reality is that there will always be small business retailers who you want to protect and allow to grow. A true small business exemption will be an incubator for new retail businesses, who we hope will graduate into any new collection regime.

Unfortunately, the authors of recent remote sales tax bills have walked away from true small business protections. Starting in 2010, remote sales tax bills dropped the term "small business exemption" and replaced it with the term "small seller exception". They want small businesses to be collecting online everywhere. Obviously, we disagree.

Misleading Data

Additionally, there have been studies that claim that S. 1832 protects 99.7% of online sellers. This report is very misleading, as it does not differentiate between casual sellers who occasionally sell on the Internet and actual small business retailers that use the Internet as part of their business. It is misleading to include occasional sellers in a study that claims to illustrate the impact of a tax increase on small business. No one expects a casual seller to collect and remit sales taxes; the same way no one expects a garage sale to collect sales taxes. Distorting retailer

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[2] "Uncollected Sales Taxes on Electronic Commerce: A Reality Check"; Eisenach and Litan: 2010.
[3] "The Fiscal survey of States: 2011" :
http://www.nasbo.org/sites/default/files/2011%20Fall%20Fiscal%20Survey%20of%20States.pdf

data by including millions of consumers who occasionally sell on the Internet is an effort to hide the real negative impact on real small business retailers who are working to provide meaningful competition to established retail giants.

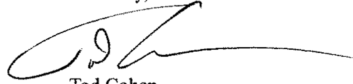
Real Small Business Protection

If you believe that real small businesses should not be harmed by a change in remote sales tax law, then the definition of a small business is an important one. Congress traditionally delegates authority to the Small Business Administration (SBA) to set small business size standards. The SBA's unique position allows it take into account the intricate differences in diverse business models. [4] We think that the SBA is the appropriate authority for defining which small business retailers should continue to operate under current law.

For all of these reasons, eBay strongly supports S.Res. 309. This bipartisan resolution opposes new tax collection requirements for small online businesses and entrepreneurs. The Resolution, which was introduced Senators Wyden and Ayotte, calls for policies to maintain the principle that small businesses should not be held to the same standard as large retail businesses with significant presence.

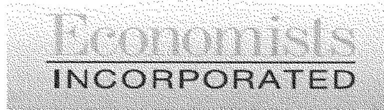
To conclude, eBay's business is tied to the success of the small businesses that use our platform. Not surprisingly, our focus has been to protect small business retailers using the Internet. eBay supports a robust Small Business Exemption being included in any new remote sales tax regime and will continue to urge members of the Committee to do the same.

Sincerely,



Tod Cohen
Vice President and Deputy General Counsel, Government Relations
eBay Inc.

[4] Small Business Administration 2012 size standards: http://www.sba.gov/content/table-small-business-size-standards



Online Retail Sellers and Sales Volume Thresholds

Laura A. Malowane, M.B.A., LL.B., Ph.D., and Stephen E. Siwek, M.B.A.
Economists Incorporated[1]

April 2012

This report presents estimates of online retailer counts and sales in the United States. The report was prepared at the request of Amazon.com.

Introduction

Congress faces important questions in the context of "Marketplace Fairness" online sales tax collection legislation, particularly with respect to the establishment of a "small seller exception." The SSE is the minimum sales threshold above which online retailers would be required to collect sales taxes. With such an SSE, Congress would deny states the choice of whether to require online sellers below the threshold to collect sales tax like their main street competitors.

Key questions are: What fraction of ecommerce is conducted by sellers with various sales volumes? And what portion of online sellers sell more than a specified annual sales volume? Or, in a specific example: what is the minimum annual sales volume earned by the Top 1% of online sellers?

Although little information is directly available about the total online interstate sales of any but the very largest volume sellers, answers to these questions can be reliably calculated by extrapolating from the available data. The following brief report provides the basis and results of such calculations.

Objective

The purpose of our study of ecommerce was to determine the number and percentage of US online sellers above and below various annual sales volume thresholds. Given that there are many millions of online sellers, it is fairly obvious, for example, that there are far fewer sellers that sell *more* than $500,000 annually than there are sellers that sell *less* than $500,000. The core question, then, is how many – and what percentage of – sellers have sales above and below such a threshold?

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[1] Economists Incorporated is an economic research and consulting firm with offices in Washington, D.C., and San Francisco, CA.

Estimating the Distribution of Online Retailers

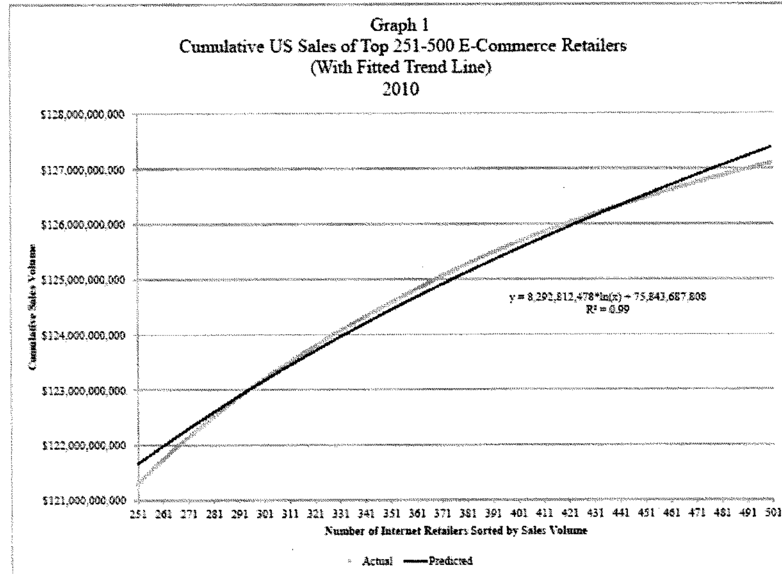
When economists arrange sales data for large populations of enterprises in order of their sales volume, they frequently derive, in statistical form, the linear or nonlinear "curve" that "best fits" the distribution of the available data. If details are known about only a portion of the distribution, details about the remainder of the distribution can be calculated with considerable precision so long as the total number of enterprises in the population is known or can be reasonably estimated.

In the case of US ecommerce, there is a wealth of information available about the largest 500 online sellers and so, by extrapolating from this information, the online sales levels achieved by less-large, medium, and small sellers can be calculated with confidence. We have done this and conclude that, conservatively assuming there are only five million US online sellers, only one percent of US online sellers have more than $150,000 annually in remote sales. Details of our analysis follow.

Analysis

To determine the online sales of different volume sellers we began with the most recent data available; 2010 ecommerce sales data from the *Internet Retailer: Top 500 Guide, 2011 Edition*. In 2010, the largest 500 ecommerce sellers ("Top 500") had combined global sales of $150 billion. We adjusted this total in order to derive an estimate of the Top 500's US-only sales. To do this we compiled the actual North American sales achieved by the largest online seller. Based on information provided by the Top 500 Guide, we then assumed that about 94% of all the other sellers' ecommerce sales were US sales.

Next, we arrayed the Top 500 sellers from largest to smallest (i.e., we ranked them 1 through 500 based on sales). This enabled us to evaluate how sales per seller decline as the ranking of the seller increases (or, said another way, how cumulative sales of all sellers at or below that ranking begin to flatten as the ranking of the seller increases). In order to calculate this relationship for the 501st seller and beyond, a logarithmic curve was fit to the cumulative sales data for the 251st to 500th sellers (which we found to provide more robust predictive power for both smaller retailers and the industry as a whole than if all the Top 500 sellers were included). The resulting chart is shown in Graph 1.



The computer-derived equation for the curve in Graph 1 is:

*y = $8.29 Billion * ln (x) + $75.84 Billion*; where x represents the rank of a particular seller and y represents the $ cumulative sales for all sellers up to and including the sales of the seller at rank x.[2]

We used this curve and equation to extrapolate how sales per seller will continue to decline beyond the largest 500 sellers all the way to the very smallest volume sellers. That is, more crucially for the purposes of Congress, the equation for this curve can be used to estimate the sales volume per seller at any particular sales rank. The equation for such a calculation is:

---

[2] The precise formula for this equation is y = $8.2928 Billion ln (x) + $75.8437 Billion

*z = $8.29 Billion * [ln (x) – ln (x-1)]*; where z represents the $ sales of the seller at rank x.[3]

Finally, because the questions before Congress are centered on interstate (a.k.a., "remote") sales, we endeavored to correct for in-state (local) sales on which we, again conservatively, assumed that taxes already are being collected. To do this we began with the Top 500 sellers and examined individual seller websites and annual SEC filings to determine in which states each seller has nexus. We then apportioned each seller's US ecommerce sales by state using a weighting of gross domestic product by state. Each seller's remote sales were calculated to include only those sales in states in which they do not have nexus. To estimate the remote sales of sellers above the 501st ranking, we used the data and above methodology for the 451st to 500th seller, which resulted in an assumption that 93% of total ecommerce sales by sellers not in the Top 500 are remote.

Results

From these equations, the number and percentage of sellers above and below various sales volume thresholds can be calculated. Table 1 presents sample results very conservatively assuming only five million total US online sellers.[4] A few years ago, eBay reported that it alone had well over 20 million sellers worldwide; if just – and very conservatively – a third of those are US sellers, the eBay ecommerce platform alone would have over seven million sellers.[5]

Table 1

Sales Threshold	Sellers Above Sales Threshold	
	Number	Fraction
$150,000	50,000	1%
$250,000	30,000	0.6%
$500,000	15,000	0.3%
$750,000	10,000	0.2%
$1,000,000	7,500	0.15%

As shown in Table 1, for example, the ecommerce remote sales made by the lowest selling seller in the top one percent (*i.e.*, the seller ranked as the 50,000th *largest*) is roughly $150,000. That is, less than one percent of online sellers have remote sales above $150,000. Further, only the fraction 0.0015 (*i.e.*, 0.15 percent or just *three-twentieths of one percent*) of sellers have annual remote sales that exceed $1,000,000. Note also that a very large fraction of total remote sales – representing an equally large fraction of available revenue to the states – is from sellers below this threshold. Indeed, by our

[3] The precise formula for this equation is z = $8.2928 Billion * [ln (x) – ln (x-1)]
[4] *See* "The Long Tail is Longer than You Think," Bailey, et al., University of Maryland (2008).
[5] http://files.shareholder.com/downloads/ebay/635891719x0x292439/4d7755b4-c83a-470a-b96f-4f94cb2e488c/eBay_JDEuropeMarketingMay2009_FINALFINAL.pdf

calculations, 31% of remote taxable sales would come from sellers with remote sales volume below $150,000 per year and 39% would come from sellers with remote sales volumes below $500,000 per year.[6]

In the context of the Marketplace Fairness legislation before Congress, if the small seller exception were set at $150,000 in remote sales, about 50,000 sellers would be included within this largest 1% of sellers, and the remaining over 4,950,000 ecommerce sellers – about *99%* of online sellers – would *not* be subject to online sales tax collection.

In order to assess the sensitivity of these results to our assumed 5 million sellers figure, we performed similar calculations with varying assumptions about the total number of US ecommerce sellers. With even more total sellers assumed, the lowest volume seller in the Top 1% of sellers is smaller. For example, by assuming 10 million online sellers, a seller with $83,000 of annual remote sales would be in the Top 1%, or assuming 12.5 million sellers reveals that a $66,000 per year seller would be in the Top 1%. But, again, very conservatively assuming only five million total online sellers, the Top 1% of sellers includes only those with annual remote sales above $150,000 and, thus, a small seller exception set at $150,000 would exclude 99% of online sellers.

****

[6] Remote taxable sales exclude estimates for the following items: 1) online sales in states with no sales tax; 2) online motor vehicle sales; and 3) sales of non-taxable products such as contacts lenses.

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April 23, 2012

Honorable Max Baucus
Honorable Orrin Hatch
Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD-219
Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Re: April 25, 2012 Hearing on *Tax Reform: What it Means for State and Local Tax and Fiscal Policy*

Dear Chairman Baucus, Ranking Member Hatch and Members of the Committee:

On behalf of FASTSIGNS International, Inc., I would like to thank you for holding this hearing and urge the Committee to address a state tax issue of critical importance to our company: business activity tax nexus. At its most basic, the issue involves the connection that a state must have with a company before it is constitutionally authorized tax its income. We believe that Congress must act to protect interstate commerce from overly aggressive state taxation by enacting the Business Activity Tax Simplification Act ("BATSA"), H.R. 1439.

FASTSIGNS is a franchisor of sign and graphic businesses. We have 470 locations within the U.S. Each of our franchised locations pays federal and state income taxes in the states they are located. Our corporate office is in Carrollton, Texas, a Dallas suburb. We have field-based employees in 8 other states.

Like all franchise companies, our business model involves the license of our trademark and other intellectual property to franchisees located across the country. Although our franchisees are physically present in 45 states, FASTSIGNS International maintains property, employees and/or offices only in 9. While our employees make occasional visits to our franchisee's places of business, the duration of such visits is limited, and the services that we furnish to our franchisees are implemented almost entirely at our principal offices and by means of telephone, the Internet and the mail.

FASTSIGNS International, Inc.
2542 Highlander Way, Carrollton, TX 75006 | o: 214-346-5600 | 972-248-8201 | fastsigns.com

Traditionally, the states did not attempt to subject non-resident franchisors to business activity taxes on royalty income unless the franchisor clearly established a physical presence in the taxing state by owning or leasing real property, operating its own outlets or maintaining an office or employees in the jurisdiction. (Keep in mind that those states already – and appropriately – tax the income of the franchisees located in their jurisdiction.) Recently, however, some states have argued that the mere presence of a franchisor's intangible property in their jurisdiction satisfies the "substantial nexus" requirement mandated by the U.S. Constitution's Commerce Clause for state taxation of non-resident businesses.

Taken to their logical extreme, these new arguments for state tax nexus would result in our company being subject to income taxation, including interest and penalties, by every state in which we have a franchisee. That scenario would represent a radical departure from the traditional reach of state taxing authority, and it would result in an enormous increase in our tax liability and related compliance burdens.

In the past 24 months, the following states (where we have no physical presence nor employees) are making a case that we owe tax: Arizona, California, Missouri, Oregon, Pennsylvania, South Carolina and Wisconsin. This uncertainty makes it very difficult to conduct business.

Clearly, federal legislation is needed. BATSA would clearly define when companies should be obliged to pay business activity taxes while preventing arbitrary state taxation of interstate commerce. FASTSIGNS International is committed to paying all tax rightfully owed. But, clear, predictable and fair standards for state taxation of interstate business are essential to the future health and growth of companies like ours. Absent enactment of BATSA, our business and others similarly situated will suffer contractions of investments, reduced employment and a decline in profits. Given the current state of the economy, that scenario presents a real threat to our survival.

Thank you for the opportunity to present these comments.

Sincerely,

Catherine Monson
Chief Executive Officer

CM/gf

FEDTAX

STATEMENT SUBMITTED FOR THE RECORD TO

THE UNITED STATES SENATE COMMITTEE ON FINANCE

FULL COMMITTEE HEARING

TAX REFORM AND WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

APRIL 25, 2012

DIRKSEN SENATE OFFICE BUILDING
WASHINGTON, DC 20510-6200
ATTN: EDITORIAL AND DOCUMENT SECTION
RM. SD-219

STATEMENT SUBMITTED BY

R. DAVID L. CAMPBELL
CHIEF EXECUTIVE OFFICER

AND

JOAN WAGNON[ii]
EXECUTIVE VICE PRESIDENT

THE FEDERAL TAX AUTHORITY, LLC
162 EAST AVENUE
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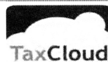


Alexander Hamilton wrote in *The Federalist* in 1788 that "individual States should possess an independent and uncontrollable authority to raise their own revenues for the support of their own wants."

Today the discussion about state sovereignty over matters of taxation continues unabated. State revenue directors have seen firsthand how the actions of the federal government have affected state and local revenues. Members of Congress are increasingly bombarded by requests for action because state laws are restrictive to business or seen as unfair. There are any numbers of examples where congressional action has been beneficial or harmful to states.

But the issue that has been most devastating to state and local government has resulted from Congressional inaction, rather than action: the failure of Congress to overturn Quill v North Dakota.[iii]

The Marketplace Fairness Act (MFA), S. 1832, sponsored by a bipartisan group of senators (Enzi, Durbin, Alexander, et. al.) is a good solution to the revenue problems of states, but more importantly, it gives states a better mechanism than they have now to collect the taxes they already levy.[iv]

The MFA also corrects a growing imbalance between groups of retailers. Under the current court ruling, tax is collected on some sales and not on other sales of the exact same items. Why should tax be collected on a book or camera purchased from a local business and not on an identical item purchased from a mail order or internet business?

Remote sales are growing at double digit rates.[v] However, states' inability to collect sales tax on these sales results in the erosion of the states' tax bases. Certainly this unfairness is not the hallmark of good tax policy! Congress is creating winners and losers among the retail community by its inaction.

Opponents cite two specific reasons for allowing this unfair situation to continue: a) that remote collection would be overly burdensome and complex, and b) that any systems necessary for remote collection would be prohibitively costly. This testimony will provide technical information for Congress to consider when evaluating those arguments.

I. THE COMPLEXITY ARGUMENT

Technology has advanced considerably since the 1967 and 1992 Supreme Court rulings that created the current sales tax situation. Even the more recent of these, *Quill*, occurred before the first graphical browser was invented, before most homes had internet connections, and long before e-commerce forever changed the retail landscape. Today, forty-five years after *Bellas Hess* and twenty years after *Quill*, online marketplaces and auction sites easily manage millions of items for sale at any given moment.

Today, keeping track of a few thousand local tax rates and filing requirements is not an insurmountable technical, administrative, or financial burden. TaxCloud, the sales tax management system created by FedTax, proves this point by calculating and collecting sales tax on any purchase for any tax jurisdiction in the United States *in less than one second.* The service is free to all retailers.

The technologies necessary to create such a system are not new; they are well-established. In fact, they are currently being used throughout e-commerce. They are Application Programming Interfaces and Web Services. An Application Programming Interface (API) allows dissimilar and unrelated systems to communicate with each other using pre-established syntax and structure. Web Services allow APIs to be used for machine-to-machine interactions over the internet. Both are now commonly used in e-commerce—for example, in real-time-shipping, which allows a retailer to provide its customers with accurate, real-time quotes for shipping costs based on at least five variables, including weight, size, delivery speed, origin, and destination. Often customers can even compare shipping costs among multiple shippers.

With APIs, Web Services, and other technological advances of the past twenty years, it is now possible for remote retailers to easily keep track of every state's tax laws.

To minimize or completely eliminate the undue burdens cited in *Bellas Hess* and *Quill*, more than half of the states with sales tax have worked together for twelve years to create the Streamlined Sales and Use Tax Agreement (SSUTA). These states provide free rates and boundaries databases for all of their respective taxing jurisdictions, and regularly issue updates when rules, rates, or boundaries change. In addition these states also certify and pay for software and service providers to manage sales tax compliance on behalf of retailers.[vi] The Marketplace Fairness Act requires that any states seeking remote collection authority shall comply with SSUTA or provide comparable rates and boundaries information as well as certified software and services that retailers can rely upon to achieve compliance with minimal burden.[vii]

Ironically, those who argue most strenuously that remote collection would be too complex are a few large online businesses that already rely on these same technologies every day, in every transaction. The plain fact is that online retailers operate the largest marketplaces in the world by relying on technology to simplify and automate a host of historically burdensome chores, including payment automation, location-specific marketing, personalized recommendations, and even Duties and Value Added Tax management for foreign governments.

II. THE COSTS-OF-COMPLIANCE OR UNDUE BURDEN ARGUMENT

Opponents also argue that even if technology can solve the technical burden of keeping track of rates, jurisdictions, and filing complexities, such software would be prohibitively costly, particularly for small businesses. TaxCloud is provided to retailers at no cost—so the argument that such

software would be prohibitively costly should be flatly disregarded. However, the costs-of-compliance argument also maintains that even if the software is free, businesses will still be burdened with the cost of integrating such software into their existing systems.

This line of argument ignores the reality that all but the very largest retailers rely upon pre-written software and/or online hosted platforms for e-commerce and order management. Retailers rely upon these systems to avoid the costs of developing, managing, and maintaining such systems on their own, costs that are magnified by the changing nature of e-commerce. It is no secret that e-commerce is constantly changing to respond to evolving cyber-crime threats, payments and security industry best-practices, and, yes, legislative requirements. When their retailer clients need to collect sales tax, platform vendors will provide ways for them to do so, embedded within the platforms that retailers already use.

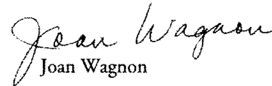
E-commerce platform vendors are intensely competitive and focused; they take pride in not only complying with evolving requirements but often surpassing them, occasionally with stunning results. For example, much of the cloud computing infrastructure now transforming every corner of the technology sector can be traced to several of the largest e-commerce companies adapting to comply with the Sarbanes Oxley Act of 2002. Most platforms already provide basic sales tax management features for their clients. Upon enactment of MFA, these existing systems will quickly be adapted to ensure compliance.

To conclude, modern technology has made it easy for retailers to collect sales tax for any state in the U.S. TaxCloud enables retailers of any size to easily collect sales tax and comply with the provisions of The Marketplace Fairness Act—for free. More information is available at TaxCloud.net.

And in addition to TaxCloud, five other companies are certified by the Streamlined Sales Tax Governing Board and ready to assist when Congress authorizes collection—and no doubt hundreds more will emerge soon after legislation is passed, because the free-market system will provide the incentive for entrepreneurs and innovators to develop these products.

Please don't wait to enact the Marketplace Fairness Act until all the parts of tax reform are in place. Passing this one bill can be the foundation for future reform as well as provide great benefit to both state and local governments. It also benefits brick and mortar retailers. Creating the same tax collection system for retailers whether they sell online on in a store is only fair.

R. David L. Campbell
Chief Executive Officer



Joan Wagnon
Executive Vice President

Endnotes

[i] David Campbell, Chief Executive Officer of The Federal Tax Authority (FedTax), founded the company in 2008. FedTax is a Washington State Limited Liability Company with operations in Washington, Connecticut, and Kansas. Its management team includes highly experienced professionals who have been directly involved in building some of the most recognizable brands in e-commerce, including MasterCard, Google, WebMD, Microsoft, Expedia, and American Express.

[ii] Joan Wagnon served as Secretary of Revenue in Kansas from 2003 to 2011. She also chaired the Streamlined Sales Tax Governing Board in 2008-9 and the Multistate Tax Commission from 2006 to 2008. She served on the Board of Directors of the Federation of Tax Administrators for 8 years before joining FedTax to work toward the passage of federal legislation granting states' collection authority over remote sales.

[iii] The notion that out-of-state retailers would find it overly burdensome to keep track of every state's sales tax rules can be traced directly to the 1967 Supreme Court ruling in *National Bellas Hess v. Illinois Department of Revenue*. In its majority opinion, the court ruled that "the **many variations in rates** of tax, in allowable **exemptions**, and in administrative and **record-keeping requirements** could entangle National's interstate business in a virtual welter of complicated obligations to local jurisdictions" (emphasis added).

In 1992, the matter of remote sales tax collection came before the Supreme Court again in *Quill v. North Dakota*. This time, the court reaffirmed the earlier *Bellas Hess* decision by a ruling of 8 to 1, primarily on the basis of *stare decisis*. The ruling went on to state, "[O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve."

FedTax frequently cites the earlier *Bellas Hess* quote because it summarizes the ruling's basis in complexity and burden, which has rippled forward to the present day and created a tidal wave of unintended consequences. This ruling has shielded all out-of-state retailers from the obligation to collect sales tax, based purely on the notion that it would place too much of a burden on businesses. Perhaps it would have, in 1967. That was the year the floppy disk was invented at IBM.

[iv] States typically depend on voluntary means of collecting from individuals, such as a voluntary line on the income tax form. Audit procedures, which are used for businesses, are ineffective for consumers.

[v] On Cyber Monday (the first Monday after Thanksgiving) in 2011, over $1.2 billion in sales were transacted online. On that day alone, approximately $58 million in sales tax went uncollected.

[vi] FedTax has been designated a Certified Service Provider (CSP) by the Streamlined Sales Tax Governing Board specifically for its TaxCloud service. There are six CSPs and 24 member and associate member states.

[vii] Although "software and services" is not defined in the Marketplace Fairness Act, likely it will include Application Programming Interfaces (APIs), Web Services, rates and boundaries databases, and a process for certifying service providers to process returns accurately under state laws.

Statement
of the
Federation of Tax Administrators

On the Topic of

Tax Reform: What it means for State and Local Government Tax and Fiscal Policy

Committee On Finance
United States Senate

April 25, 2012

For additional information call:
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Introduction

The Federation of Tax Administrators (FTA) is an association of the tax agencies in the 50 states, District of Columbia and New York City. Its members are responsible for collection of state tax revenues and administration of state tax laws. Federal tax reform issues can affect state tax administration and state tax revenues by billions of dollars. The relationship between state and federal taxation is one of the cornerstones of our nation's Constitutional framework, and we appreciate the Committee's recognition that the federal and state structures are an interrelated system.

FTA's mission encompasses matters that affect fairness, burden and conformity. In terms of this hearing, others are best suited to address certain issues before the Committee, including the interest exemption for state bonds and the deductibility of state income and sales taxes. FTA has, however, long supported Streamlined efforts to simplify sales taxes, but has also opposed certain federal legislation that would unduly constrain the ability of state and local governments to set their own tax and fiscal policies.

The most critical tax issue facing states is the application of sales tax to sales by remote sellers. Granting states the authority to require all sellers to collect sales taxes from all customers will level the playing field for competing businesses, improve compliance with taxes that are already owed and remove artificial restrictions that inhibit business investment. The second-most critical issue is the extent to which preemption bills currently pending before Congress, like the Digital Goods and Services Tax Fairness Act, would limit or alter constitutional and administrable state tax laws.

Leveling the Playing Field for Sellers

FTA supports the objectives of S. 1832, the Marketplace Fairness Act. The establishment and explosion of the Internet as a marketplace has redefined the world of commerce forever. At one time considered principally an enforcement problem for the states, the disparate tax treatment between remote and local sales, which has existed for many decades, now poses challenges for "bricks and mortar" and Internet businesses alike. This legislation should not be delayed or encumbered by special preemption legislation.

The Marketplace Fairness Act and related bills respond to the U.S. Supreme Court's decisions in *National Bellas Hess* and *Quill.*[1] These decisions are widely read to exempt a seller from collecting sales tax from customers who are in a state where the seller has no physical presence. These taxes are owed but frequently go unpaid, giving the seller in that case a competitive advantage over traditional retailers.

We have provided technical comments to the Committee on elements in any legislation that would assure the maximum participation of the states under the Act. The most important of these elements are:

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1 *National Bellas Hess, Inc. v. Illinois Dep't of Revenue*, 386 U.S. 753 (1967) and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

- Authority granted to states that are either members of the Streamlined Sales and Use Tax Agreement (SSUTA) or that choose to conform their laws to federal statutory standards.
- Ability for states to designate the specific taxes covered by the generic phrase "sales and use taxes."
- Flexibility to recognize exceptions from uniform rate and base requirements that have already been agreed to between states and industry groups under SSUTA.
- Authority for states to continue to impose origin sourcing for intrastate sales or sales by non-remote sellers.
- Recognition that states may have additional ways of lowering burdens on remote sellers and the retention of authority for states to use these approaches as well.
- Preservation of state authority to require sellers to maintain necessary records.
- Exclusion of any mandatory vendor compensation provision, as this requirement would significantly reduce state participation.

Effects of Preemption Legislation

Congress is considering bills that would restrict the authority of state or local lawmakers to design tax policies best suited to their constituencies. State lawmakers have responsibility for governmental programs and fiscal policies. Imposing restrictions on state tax policy constrains the ability of state lawmakers to serve their electorates. Restrictions can also make it difficult to administer and enforce state tax laws.

FTA recognizes the role of Congress in regulating interstate commerce. We evaluate federal laws that would limit or preempt state taxes against certain criteria, including whether 1) there is objective evidence that state policy has unduly affected interstate commerce; 2) states are working on a solution; 3) the proposed federal law would negatively affect state revenue; and 4) the law is likely to have unintended consequences.

With these criteria in mind, we offer select comments about bills that are now or may soon be before the Committee.

The Digital Goods and Services Tax Fairness Act
Illustrates FTA's Opposition to Preemption Legislation

The Digital Goods and Services Tax Fairness Act of 2011 (H.R. 1860 and S. 971) fails to meet many of the criteria FTA uses to evaluate preemption legislation.

1. **Is There Objective Evidence that State Policy has Unduly Affected Interstate Commerce**? There is no discernible, let alone pressing, need for the legislation. States do not widely subject digital goods or services to taxation (with the long-standing exception of software). They are not therefore discriminating against digital goods and services. Indeed, they cannot. Doing so would be illegal under the Internet Tax Freedom Act (ITFA), which specifically prohibits multiple or discriminatory taxes on electronic commerce. No state or local tax law has been invalidated based on the ITFA.

2. **Will the Legislation Negatively Affect State Revenue?** The states that have closely examined this bill believe they would suffer significant revenue losses. The bill relieves sellers from general record-keeping requirements and makes sourcing elective to such an extent that the bill invites abuse.

3. **Are States Working on a Solution**? Members of the SSUTA are working with representatives from industry and business groups to address sourcing issues for sales of digital goods. The confluence of the SSUTA project with debate on the Marketplace Fairness Act could create a false impression that there is a relationship between the two. We ask the Committee to recognize that there is not.

   This work should be allowed to continue in its present forum. Creating such a policy requires the flexibility to adjust to new business models and technologies over time without the rules of taxability being set in stone by federal law. The solution is evolving because the field is evolving. No federal law can be expected to adapt itself to this rapidly shifting field of technology.

4. **Is the Law Likely to Have Unintended Consequences**? Many of the terms are undefined or poorly defined. This will create uncertainty, disruption of tax administration and litigation.

FTA has discussed its concern over the effects of the bill at great length with the Committee on the Judiciary in the House of Representatives and with industry representatives. We have provided written comments on virtually every provision, with examples of problems that result from each.

Further objections to S. 971 include:

- The legislation grants advantages to large businesses over small in-state businesses.
- It waives the Tax Injunction Act.
- The only way the bill works as intended is for it to apply to all excise taxes, not just general sales taxes.
- The bill's numerous technical deficiencies are too long to list but include:
  - Sourcing rules have many terms that are either not defined or are insufficiently defined; and
  - Rules exempting "intermediaries" from having to collect taxes open tax avoidance opportunities.

Other Special Preemption Legislation

There are eight other bills[2] pending in the Senate and House that would preempt state or local

[2] The bills not listed here are:
End Discriminatory State Taxes for Automobile Renters Act of 2011 (H.R. 2469)
State Video Fairness Act of 2011 (H.R. 1804)
Permanent Internet Tax Freedom Act of 2011 (S. 135)
The Telecommuter Tax Fairness Act (S. 1811)

taxes for the benefit of some interest group. In each case, we believe federal interference in the taxing authority of state and local governments is unwarranted. These would cause the greatest harm:

The Wireless Tax Fairness Act of 2011 (H.R. 1002 and S. 543)
This bill would create a five-year moratorium on changes to wireless tax laws that do not conform to the bill's ill-defined standards of what is a "discriminatory tax." If a state or local government changes an existing statute, the new law could be voided by judicial challenge. The result would be to eliminate ongoing state efforts to reform and simplify their taxation of telecommunications and related communications services.

A bill … to repeal certain communications taxes and for other purposes (S. 1934)
This bill would make permanent the moratorium on taxation of charges for Internet access. It further includes a prohibition of tax on "amounts charged or retained for facilitating the booking of air transportation, hotel accommodations, car rental or other travel-related services." The portion of this bill dealing with hotel taxes alone could result in an annual revenue loss of $2 billion to $3 billion.

The Mobile Workforce State Income Tax and Fairness Simplification Act of 2011 (H.R. 1864)
As originally drafted, this bill would have prevented states from taxing income earned in the state unless the individual was present for more than 60 days. Proponents are now seeking a 30-day threshold. Among the technical deficiencies, there is no dollar-threshold exclusion, presenting tax avoidance opportunities for the highest-income workers. The bill also relieves employers from any obligation to keep records in the manner traditionally required for compliance purposes. In response to this bill, the Multistate Tax Commission engaged with industry groups to come up with a structure that both industry and the states could support. FTA has participated for years in extensive discussions with industry representatives under the auspices of the Committee on the Judiciary in the House of Representatives on both substantive and administrative issues that, unless corrected, we believe will undermine state income tax enforcement. The State of New York alone would experience a revenue loss of $106 million annually from this proposal.

The Business Activity Tax Simplification Act of 2011 (H.R. 1439)
This bill would fundamentally and substantially narrow the states' authority to tax business activity within their borders. (It imposes the same outdated construct that the Marketplace Fairness Act seeks to repeal.) Enforcement of state corporate income taxation of large interstate and international businesses would become so difficult that unprecedented tax-avoidance opportunities would result. The bill would reverse years of judicial precedent finding that such taxes are fair. The National Governors Association estimated that this legislation could grow over time to $7.9 billion annually; the Congressional Budget Office estimates that it will cost $2 billion in the first year alone.

Again, we thank the Committee for the opportunity to present our views on the important implications of tax reform for state and local government tax and fiscal policy.

Letter of Support by Mark B. Wieser

Founder of Fischer & Wieser Specialty Foods, Inc.
411 South Lincoln Street
Fredericksburg, TX 78624

to the

United States Senate Committee on Finance
for the hearing on

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

Chairman Baucus, Ranking Member Hatch and Members of the Committee, I would like to commend you for holding a hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy," and I respectfully urge that you consider the important issue of nexus rules applicable to state assessment of business activity taxes against nonresident companies. All companies doing business in interstate commerce, especially small businesses like ours, urgently need Congress to enact a federal solution like the Business Activity Tax Simplification Act (H.R. 1439).

I am the founder and chairman of the board of Fischer & Wieser Specialty Foods, Inc., located in the small Texas county of Gillespie, the same county that has produced three outstanding Americans: Fleet Admiral Chester W. Nimitz, Commander-in-Chief of the Pacific Fleet during World War II, President Lyndon B. Johnson and the former Commandant of the United States Marine Corps, General Michael Hagee.

Our company was founded in 1969, as a roadside market that I named das Peach Haus, to sell the area's delicious and famous "Fredericksburg Peaches." To supplement my market I asked my mother make her home-made jams and jellies for me to sell, and I discovered within a few years that there was a growing market for her "home-made" goodness. In 1986, with a former student, Case D. Fischer, who had worked for me all through his high school years, we incorporated the business and began marketing jams, jellies, mustards, salsas, and sauces to the wholesale trade, to up-scale department chains, and to gourmet stores under the **"Fischer & Wieser"** brand.

To give ourselves exposure we began participating in and attending area, state and, eventually, national shows. Mr. Fischer began to apply the skills he learned while studying Food Science at Texas A & M University and began developing new products by combining different fruits with the Chipotle pepper. Sampling and participating in local events and fairs convinced us that we had developed a new and exiting flavor to introduce to Americans. (We were the first to introduce the chipotle pepper to the American palate.)

As members of the **National Association of the Specialty Food Trade** (NASFT) we were permitted to enter new products into national competition if nominated and recognized by a sufficient number of members of the retail trade. In New York City, in 1997, we won the highest national award given by the NASFT for our new **Original Roasted Raspberry Chipotle Sauce™**. It was nominated for being the best selling product for that year. Since 1997, it continues to be the best selling condiment in the United States. In other words, it is a product that sells, if simply sampled by retailers. In fact it flies off the shelves. (I personally, have sold over 23 cases (276 bottles) in a single afternoon at stores belonging to national chains (Whole Foods) simply by offering a taste to passing shoppers.)

Today, Fischer & Wieser Specialty Foods, Inc. sells to retailers in all fifty states, throughout Mexico, to parts of Canada and Australia, and our first container will be shipped to the United Kingdom in March. We have also exported to Germany and

Taiwan from time to time. We sell to all the major national food chains, including Costco, Sams, Kroger, Safeway and a host of regional, up-scale groceries. By 2005 Fischer & Wieser products had captured 2.7% of the national specialty marinade market for companies having more than ten million in annual sales.

We employ approximately seventy-five employees and are the largest privately-owned business in our small town. Our weekly payroll injects over forty thousand dollars into our local economy. Unfortunately, what most people do not understand about food manufacturing is that the margin (profit) is very small. In the grocery trade, **net profits** near 3% are considered excellent.

Our introduction to the Business Activity Tax Nexus issue was sudden and came as a complete surprise. I have to admit, I had never even heard of the term until 2007, when the company received a questionnaire from the State of Washington, asking if we were selling products there, if we had visited anyone in the state, and a number of other questions that we thought were for the purpose of completing a survey. We completed the form and returned it. There was no indication whatsoever in that questionnaire that the State of Washington was going apply a tax on our sales. Given that our company has never had a physical presence in Washington, we were quite shocked when we were assessed more than $15,000.00 in taxes and penalties for the previous five years, merely for selling to businesses headquartered in that State.

We paid the taxes that were assessed, and I began to research what Nexus was all about. Meanwhile, we appealed the decision, submitting numerous court cases that supported our case to the Washington Department of Revenue. We had a final hearing in March 2010. An attorney, familiar with the state of Washington's interpretation of laws, however, had told us not to expect to win and for us to consider taking the state to court would cost more than the amount of money we were asking to be returned. Additionally, I had read that over 10,000 appeals to the Washington Department of Revenue have been made by companies, such as ours, suddenly finding themselves subject to Nexus laws. I had found no reversals up to our hearing, as its rulings were based on laws passed by the

Washington legislature, and the Washington Department of Revenue repeatedly had ruled that it was not permitted to overrule the legislature. I had also found that they consistently ignore all federal laws.

We based our appeal on **PL 86-272** after reviewing numerous court cases that have dealt with Nexus issues. We felt confident that we would not be subject to Washington taxes as we had established no **physical presence**. To support our appeal, we submitted no fewer than three dozen typical examples of activities that are typically cited to support a state's claim towards establishing Nexus, none of which we performed. We asked the State of Washington what they were using to support their claim that Nexus had been established. Unfortunately, we soon discovered that those things that normally establish Nexus did not matter, for the state of Washington felt it had no obligation to comply with PL 86-272.

We had our hearing before the Board in March of 2010 and, after giving sworn testimony, rested our case. A month later, the ruling came down, and we had won! The Department appealed, and we submitted additional written testimony. Again, the Board ruled to uphold its decision. It was a first! The Department refunded all our money with interest.

While we won, we know that other companies are still at risk, and this bill simply must be enacted into law or more and more American businesses will fall victims to unbridled states seeking revenues where ever they can find them.

The only in-state activity acknowledged by Fischer & Wieser Specialty Foods, Inc. on the State of Washington questionnaire was to acknowledge that we had sent a representative, as a courtesy, to call upon a distributor headquartered in the State. He took no orders in the state (and never has). In all the cases that we cited in our defense, such an activity had been shown in case after case not to be sufficient to confer Nexus. The State of Washington has, however, made it quite clear that, in their estimation, the sending of a representative into their State, no matter if only for a single hour, is

sufficient to establish Nexus for the assessment of income-based tax. In addition, the State claimed that we must be sending a representative into the jurisdiction to support and maintain our level of sales. This assertion is nonsense and simply not true. We have a product that taste alone sells! We are far too small a company to develop marketing plans for any state.

Additionally, Washington has made it quite clear that it considers its tax a **Business and Occupation Tax (B&O)**, and consequently argues that it is not a tax covered by PL 86-272. Specifically, the State says that PL 86-272 applies only to states that have enacted a **"Net"** income tax. Since the state of Washington has subsequently enacted a "Gross" income tax their argument is that they are not subject to the requirements of PL 86-272. As you may know, at the time that PL 86-272 was passed, few states had taxes based on "net sales." It did not necessarily take a Philadelphia lawyer for these states to figure out that if they modified their tax laws to apply to "gross sales," they could completely avoid PL 86-272. Just like little kids, states discovered new ways to avoid PL 86-272. This has become a game, and it has caused significant problems that only Congress can resolve. The U.S. Supreme Court has consistently refused to resolve this problem, recognizing the role that Congress should play in this matter. Fischer & Wieser Specialty Foods, Inc. and hundreds of small companies across the land simply cannot afford to hire attorneys to take states, such as Washington, to court to force them to abide by the intent of PL 86-272. That is why we so strongly recommend enactment of **BATSA**.

Incidentally, in my research I have discovered that the state of Washington is also of the opinion that it has the right to assert Nexus if the driver of a **common carrier** delivering product does not have the explicit authority to inspect and to reject products the driver may deem to be of questionable quality. This is just one more example of how states have circumvented the intent of federal law. What common carrier in this nation would accept or assume such responsibility?

The state of Washington has also said that they have the right to inspect our books and that we are required by its laws to keep accurate records of all shipments and to have such records available at all times and in compliance with its laws. While we have employed an independent outside audit of our books for more than a decade, we simply cannot afford the additional expense to keep separate books for every state. To comply with all laws required by the state of Washington would force us to comply with the laws of all fifty states and every taxing authority within those states. I understand that this could reasonably be determined to be more than 3,200 individual and separate taxing entities! For large companies this might be possible. For small companies this becomes an unbearable cost of doing business.

Additionally, our largest customer in the state of Washington serves as the regional headquarters for the northwestern division of Costco. It acts as the buyer for all its stores located in the States of Oregon, Idaho, Montana, Alaska and Hawaii. The State of Washington insists it has the right to tax products delivered directly to other states outside the State of Washington simply because Costco's regional office is located there. We have no way of knowing where Costco places our products or whether or not our products cross into Washington before being delivered. Consequently, we very likely are paying taxes on products that were never actually sent into that state. The consequences of this, if followed by every state, would destroy commerce in the United States.

Beginning in 2009, in an effort to avoid a claim of tax due to Washington for 2009 and years thereafter, I ordered our representatives not to enter the State of Washington. The State of Washington accepted that commitment, but advised that its laws provide that Nexus, once established, is deemed to remain in effect for five years.

Incidentally, the initial order by the Northwest Region of Costco was not the result of a sales call made by our company to the state of Washington. Fischer & Wieser Specialty Foods, Inc. first began selling to other regional divisions of Costco after their buyers called on our booth at the NASFT. NASFT national shows occur only in January or February on the west coast, normally in San Francisco, and on the east coast in June or

early July, always in New York City. It was our product's ability to produce outstanding sales in the Southwest Region of Costco that caught the attention of other Costco regional offices. The Northwest Region began to send its first orders and subsequent orders directly to our company offices in Texas upon their own initiative and without any Fischer & Wieser Specialty Foods, Inc. representative calling upon that region.

Fortunately, the State of Washington is the only state where we are not physically present that has actively sought to tax us; however, we realistically face similar taxes from all other states if BATSA does not become law. We simply cannot afford to continue to operate if we are not protected from arbitrary and unscrupulous interpretations of Nexus by the various states. The same fact holds true for thousands of small companies across this nation.

I can assure you, if Fischer & Wieser Specialty Foods, Inc. had offices, property or employees in any state other than Texas, or if it enjoyed the protections and benefits provided by the legislature of any other state, we would willingly and understandingly pay our fair share of taxes due to that state. But, for a business to be subject to state income tax based on a whim does not contribute to the economic success of this nation.

Fischer & Wieser Specialty Foods, Inc. is asking Congress to enact **BATSA**, a bill that will clearly spell out what will establish Nexus, thereby freeing small businesses from the unnecessary costs incurred in by the need for constant court cases and appeals. Many of us thought that all the issues relating to commerce between the states had all been resolved when the Articles of Confederation were set aside in favor of a new Constitution. It had become so very clear and so thoroughly understood by those who believed in forming a better and more perfect union that this nation could not grow strong if each state restricted the exercise of a national free trade. Those patriots understood the problem and resolved the problem. I am simply asking that this Committee clarify the physical presence nexus standard and once again strengthen and guarantee forever the principle of free trade between the states.

We pray that this testimony is helpful and beneficial to the Committee. Thank you.

Sincerely,

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Tax Reform: What It Means for State and Local Tax and Fiscal Policy

United States Senate Committee on Finance
Wednesday, April 25, 2012, 10:00 AM
215 Dirksen Senate Office Building
Washington, D.C.

Honorable Members of the Committee:

As a freshman member of the Warr Acres OK City Council I was in shock when I discovered that 91% of our city's funding is sales tax. Imagine if you will that if only 10% of those purchases are done online without sales tax collected. The city of Warr Acres would be losing approximately $560,980 in revenue annually. With fewer than ten thousand residents, that mere 10% does not include the State of Oklahoma's portion of the sales tax remitted.

As online shopping grows, cities grow more dependent on consumers' voluntary remission of their "use tax". Warr Acres could raise its sales tax rate. However, if we did, we would drive an even larger wedge between the uncollected sales tax online and our local retailers, causing an even larger unfair advantage. This loophole is already causing local businesses to close their doors. At what point do we say enough is enough? I think the time is now.

Currently the City of Warr Acres is struggling to fund even the simplest of projects like patching cracks in city streets, replacing old fire trucks or even just hiring additional police officers. These are items that need to be done and are expected by the residents of our city. Want to boost our local economy, please allow our state and local governments the power to collect the sales tax that is due to them.

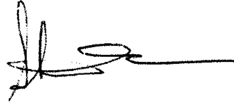
As I canvased my areas before my election, I spoke with many of the residents of Warr Acres. I learned that most of these residents had no idea that sales tax was even owed for online purchases. Why don't they know? Because many in federal and state leadership do not acknowledge that the problem exists and furthermore are afraid that rewriting and enforcing existing laws might cost them an election. It is for this reason, I am so grateful to the members of the Senate Finance Committee for taking on this issue on behalf of our nation's cities and towns and will be relieved to see legislation, such as S. 1832 The Marketplace Fairness Act, moved out of committee and passed into law.

As a small business owner in Oklahoma City I have an even broader perspective on sales tax fairness. I am co-owner of a brick and mortar store along with an e-commerce website. I have watched over the years as my brick and mortar sales have continually struggled while my internet sales have somewhat increased. The amazing thing is even though I have software in place to collect nationwide sales tax I would be foolish to do so. For now, my website does collect sales tax for Oklahoma. Not surprisingly, I've had no purchases from within Oklahoma, presumably for that very reason. It is the same website; yet out of state customers use it while in-state customers do not.

In my brick and mortar store I see several customers per week coming into my store. Engaging and asking my expertise about a product only to leave and purchase the same item for the sale price online minus the sales tax. I have even had customers attempt to return products they purchase from me in my store unless I discount the product to include sales tax so it matches online prices.

I sincerely appreciate the opportunity to provide my testimony on this subject as a city official, an online vendor and a brick and mortar business owner. I trust the committee will consider the plight of Oklahoma cities and towns and business owners like me as you consider tax reform issues relating to sales tax and the internet.

Respectfully,



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Official Testimony

Informing the debate over tax policy nationwide

How Federal Tax Reform Can Help or Hurt State and Local Governments

Matthew Gardner, Executive Director of the Institute on Taxation and Economic Policy

Testimony before the Senate Committee on Finance, United States Senate for Hearing:
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

Thank you for the opportunity to submit this written testimony. My name is Matt Gardner and I am the Executive Director of the Institute on Taxation and Economic Policy (ITEP), a Washington-DC-based nonprofit research group. ITEP's research focuses on federal and state tax policy issues with an emphasis on the goals of sustainability, transparency and fairness in the tax laws.

Federal tax reform can affect state and local taxes in several ways. The federal government can create, repeal or change tax expenditures in a way that is passed on to the states because virtually every state has tax rules linked to the federal rules. The federal government can subsidize state and local governments' ability to raise taxes and can subsidize their ability to borrow funds to finance capital investments. Finally, the federal government can regulate state and local governments' ability to raise taxes in a way that coordinates and harmonizes their tax rules or in a way restricts their taxing power and makes their tax systems more complex.

My testimony makes four points.

1. Federal tax reform can provide state governments an opportunity to improve their finances by repealing or reducing tax expenditures.

2. The federal income tax deduction for state and local taxes is indeed a tax expenditure that reduces the amount of revenue collected by the federal personal income tax, but in many ways is more justified than many other tax expenditures.

3. The federal government's practice of not taxing the interest income on state and local bonds is an inefficient way to subsidize state and local governments, and the President's proposal to extend Build America Bonds would mitigate this problem.

4. When lawmakers consider legislation intended to coordinate tax rules among the states, they must distinguish proposals that will truly achieve this result (like the Marketplace Fairness Act) from those that simply restrict states' taxing powers at the behest of corporate interests (like the Business Activity Tax Simplification Act).

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Federal Tax Reform Can Provide State Governments an Opportunity to Improve Their Finances

Federal tax reform can have a major impact on state and local taxes and revenues most obviously because virtually every state has tax rules that are linked to the federal rules. For example, many states have personal income taxes and corporate income taxes that have the same "base" as the federal personal income tax and corporate income tax, which is another way of saying they follow the federal rules to define what income is taxable. This is true even though these states have their own rate structures, which are not linked to federal income tax rates in any way.

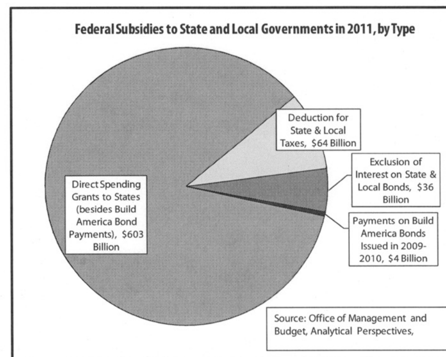
A federal tax reform that eliminates or reduces many of the deductions and exclusions used in calculating federal income taxes would automatically do the same for most state governments, but state income tax rates would be left unchanged because they are not linked to the federal rules. This would, of course, increase state revenues unless states subsequently act to reduce their tax rates or make some other changes.

Indeed, this is what occurred following the Tax Reform Act of 1986. Provisions of the 1986 act that closed federal income tax loopholes expanded the income tax base for states. Some states responded by cutting their tax rates while others used the increased revenues to finance public investments.

This could be particularly important today, as state governments have just experienced the greatest drop in revenue on record. For the fiscal year that is about to begin, 30 states projected budget gaps (some of which have already been closed) totaling $49 billion. Ten states still have budget gaps (totally $3.7 billion) for the current fiscal year.[1]

These gaps are small compared to the $530 billion in budget gaps the states faced and closed over the preceding four years. However, federal aid from the economic recovery act enacted in winter of 2009 has come to an end, and the resulting drop-off in spending at the state and local level serves as an anti-stimulus to the economy, potentially slowing down the recovery. The state governments' experience during the recession also begs the question of whether or not their existing tax systems — most of which are linked to federal rules — are sufficient to weather the next economic downturn.

The Federal Income Tax Deduction for State and Local Taxes Has Significant Justifications



When taxpayers calculate their federal personal income taxes, they are allowed to itemize deductions (that is, deduct certain expenses from their income to calculate taxable income) or take the standard deduction if that is greater than the sum of their itemized deductions. One of the itemized deductions that reduces federal taxable income the most is the deduction for state and local taxes.

Like many deductions, exclusions, credits and preferential tax rates, the deduction for state and local taxes is listed as a "tax expenditure" in reports compiled annually by the Congressional Joint Committee on Taxation and the Treasury

[1] Elizabeth McNichol, Phil Oliff and Nicholas Johnson, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, updated March 21, 2012. http://www.cbpp.org/cms/index.cfm?fa=view&id=711

Department. That means that the deduction is defined by analysts as a subsidy that is paid through the tax code rather than as a direct payment from the government.

The deduction for state and local taxes paid is often seen as a subsidy for state and local governments because it effectively transfers the cost of some state and local taxes away from the residents who directly pay them to the federal government. For example, if a state imposes a higher income tax rate on residents who are in the 35 percent federal income tax bracket, that means that each dollar of additional state income taxes reduces federal income taxes on these high-income residents by as much as 35 cents.[2] The state government may thus be more willing to enact the tax increase because its high-income residents will really only pay 65 percent of the tax increase, while the federal government will effectively pay the remaining 35 percent.

1. Tax Expenditure or a Way to Define Taxable Income?

Viewed a different way, the deduction for state and local taxes is not a tax expenditure at all, but instead is a way to define the amount of income a taxpayer has available to pay federal income taxes. State and local taxes are an expense that reduces one's ability to pay federal income taxes in a way that is generally out of the control of the taxpayer. A taxpayer in a high-tax state has less income to pay federal income taxes than a taxpayer with the same pre-tax income but residing in a low-tax state.

Most other itemized deductions are for expenses that the taxpayer has more control over, like home mortgage interest or charitable giving.

2. Addressing Spillover Effects of State and Local Public Investments

Another argument in favor of the itemized deduction for state and local taxes paid is that the public investments funded by state and local taxes produce benefits for the entire nation. This can be seen as a justification for the deduction for state and local taxes paid because it encourages state and local governments to raise the tax revenue to fund these public investments that the jurisdictions might otherwise not make.

For example, state and local governments provide roads that, in addition to serving local residents, facilitate interstate commerce. State and local governments also provide education to those who may leave the jurisdiction and boost the skill level of the nation as a whole, boosting the productivity of the national economy. State and local governments may have an incentive to provide less of these public investments than is optimal for the nation because the benefits partly go to those outside the jurisdiction.

It is probably impossible to quantify exactly what fraction of the benefits of public investments accrue to those outside the jurisdiction instead of those residing in the jurisdiction, but it seems unreasonable to deny the existence of these "spillover" effects.

The federal government also directly subsidizes (with direct cash payments) state and local governments to encourage them to make these public investments. Indeed, 85 percent of the federal subsidies to state and local jurisdictions in 2011 took the form of direct spending rather than tax subsidies.[3]

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[2] The Alternative Minimum Tax (AMT) and the "Pease" limitation on itemized deductions can, in some cases, limit the savings a high-income individual would otherwise derive from the itemized deduction for state and local taxes paid.
[3] Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2013, pages 252-253, 302. http://www.whitehouse.gov/omb/budget/Analytical_Perspectives/

3. Prioritize Repeal of Most Regressive Tax Expenditures First

One approach for lawmakers contemplating tax reform is to prioritize repeal of tax expenditures based on how regressive they are. This would be in keeping with special attention Congress and the public have lately paid to income inequality and tax fairness. Under this approach, it is not obvious that lawmakers would prioritize repeal of the deduction for state and local taxes, for two reasons.

First, as already explained, it might make sense to view the deduction for state and local taxes paid not as a tax expenditure, but as a way to help define income. Second, even if one does view the deduction as a tax expenditure, repeal of another category of tax expenditures (the tax preferences for investment income) would take a far higher priority.

Share of Tax Increase from Repealing Federal Tax Expenditures in 2012

Income Group	Deduction for State and Local Taxes Paid	Preferential Income Tax Rate for Capital Gains & Dividends
Lowest 20%	0%	0%
Second 20%	0%	0%
Middle 20%	3%	1%
Fourth 20%	14%	4%
Next 15%	37%	10%
Next 4%	17%	14%
Top 1%	29%	71%
ALL	100%	100%

Source: Institute on Taxation and Economic Policy (ITEP) microsimulation tax model, May 2012

For example, 29 percent of the benefits of the deduction for state and local taxes will go to the richest one percent of taxpayers this year, and 46 percent will go to the richest five percent of taxpayers. This means the deduction certainly benefits the rich disproportionately. However, the special, low income tax rate for capital gains and stock dividends is much more skewed toward the rich, with 71 percent of the benefits going to the richest one percent of taxpayers and 85 percent of the benefits going to the richest five percent of taxpayers. The fact that this income tax preference for capital gains and stock dividends has a very weak policy rationale, combined with its extremely regressive impact, should prompt lawmakers to prioritize its repeal as part of tax reform.[4]

Unfortunately, many proposals offered as "tax reform" would repeal or limit the deduction for state and local taxes paid (and other itemized deductions) but leave in place or even expand the income tax preferences for investment income.[5] This is exactly backwards.

Federal Subsidies for State and Local Debt Would Be More Efficient Under the President's Build America Bonds Proposal

In general, the federal personal income tax does not tax interest payments made by state and local governments to their bondholders. State and local governments are therefore able to pay a lower interest rate to bondholders, who will accept a lower interest payment because it will not be taxed.

Unfortunately, the amount of money that state and local governments save by paying lower interest rates is less than the amount of revenue that the federal government loses. In other words, the personal income tax exclusion for tax-exempt bond interest is an inefficient way to subsidize state and local governments because the subsidy to the state

[4] For more details, see Citizens for Tax Justice, "Policy Options to Raise Revenue," March 8, 2012. http://ctj.org/pdf/revenueraisers2012.pdf

[5] For example, the budget plan devised by Republican House Budget Committee Chairman Paul Ryan would reduce or eliminate unspecified deductions and tax credits but leave in place the tax preference for capital gains and stock dividends. See Citizens for Tax Justice, "Ryan Budget Plan Would Cut Income Taxes for Millionaires by at Least $187,000 Annually and Facilitate Corporate Tax Avoidance," March 22, 2012. http://www.ctj.org/pdf/ryanplan.pdf Other proposals go further. For example, during his 2012 presidential campaign, former Republican House Speaker Newt Gingrich proposed a "flat tax" that would actually have two rates, zero percent for capital gains, stock dividends and interest and 15 percent for other income, and would not allow a deduction for state and local taxes paid.

and local governments is less that the amount of revenue that the federal government loses. The difference is a windfall to bondholders.

This occurs because most of the bondholders have a marginal income tax rate of 35 percent (because they are high-income individuals or corporations that pay the 35 percent corporate income tax rate) who could be motivated to buy the bonds if the interest paid on them was enough to at least equal the interest income they would receive from ordinary bonds after paying income taxes on that income. But state and local governments often find that they need to make the bonds attractive to individuals with lower marginal tax rates, and thus pay interest at rates that are higher than needed to attract the majority of their bond holders (those with a marginal tax rate of 35 percent). The majority of the bondholders are thus getting a benefit in excess of what would be necessary to motivate them to buy the bonds.

In his written testimony for this committee, Frank Sammartino of the Congressional Budget Office explains,

> "In 2009, the average yield on (taxable) high-grade corporate bonds was 5.3 percent, and the average yield on tax-exempt municipal bonds of similar creditworthiness was 4.6 percent—a difference of 0.7 percentage points, or approximately 13 percent of the taxable return. That 13 percent also represents the marginal tax rate at which an investor would be indifferent between purchasing a taxable bond yielding 5.3 percent and a tax-exempt bond yielding 4.6 percent."

Sammartino goes on to cite studies showing that most of the bondholders are taxpayers with a marginal tax rate that is much higher than that and, as a result, about 20 percent of the revenues foregone by the federal government are a subsidy to these bondholders rather than to the state and local governments issuing the bonds.[6]

This problem would be remedied under the President's proposal to revive and reform Build America Bonds, a special type of bond that state and local governments were allowed to issue in 2009 and 2010 under the economic recovery act enacted in the winter of 2009. The interest paid on these bonds is not excluded from the income of the bondholders. Instead, the federal government simply makes a payment of a certain percentage of the interest payments to the state and local governments. The government issuing the bonds can afford to pay interest at market rates, and the subsidy takes the form of a direct payment that goes entirely to the state or local government. The bonds are also attractive to some tax exempt entities (like pension funds) that have no incentive to buy the state and local bonds that pay interest at lower rates but are tax-free.

The direct payments made from the federal government to the state and local issuers of the bonds issued in 2009 and 2010 equal 35 percent of the interest paid, which was particularly generous and was intended to help state and local governments weather the recession. The proposal included in the President's most recent budget plan would make Build America Bonds permanently available and would provide state and local bond issuers direct payments equal to 28 percent of the interest paid to bondholders. The Obama administration estimates that this is the rate at which encouraging a switch from traditional tax-exempt bonds to Build America Bonds would be roughly revenue-neutral for the federal government.[7]

A key point about this proposal is that it is roughly revenue-neutral precisely because it would replace a wasteful tax subsidy with a better targeted subsidy that is provided through direct spending by the federal government.

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[6] Frank Sammartino, "Federal Support for State and Local Governments Through the Tax Code," Testimony Before the Committee on Finance, April 25, 2012. http://finance.senate.gov/imo/media/doc/Testimony%20of%20Sammartino.pdf

[7] U.S. Treasury Department, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, February 2012, page 11. http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

Technically, federal tax revenue will rise (because there will be fewer taxpayers benefiting from the income tax exclusion for interest on state and local debt) and federal outlays will rise (because payments will be made directly from the federal government to the state and local governments). But from a budgetary and economic perspective, little will have changed except that the subsidy will be more efficiently targeted at the state and local governments it is intended to help.

This point has not been fully understood. For example, the Finance Committee ranking Republican, Senator Orrin Hatch of Utah, said at the hearing on this topic on April 25 that the President's Build America Bonds proposal would result in "an increase in taxes of $63 billion" over ten years and that "this would naturally increase the size of the federal government by $63 billion" over ten years.

This view fails to recognize that the federal government can provide the exact same type of subsidy through the tax code or through direct payments. Changing a tax subsidy into a direct payment is simply paying the subsidy in a different, potentially more efficient way. In the case of state and local bonds, the current subsidy provided through the tax code is less efficiently targeted to the intended recipients (state and local governments) than would be the case if the subsidy were provided as direct payments (payments made from the federal government to state and local jurisdictions to offset part of their interest expense).

Lawmakers Must Distinguish Proposals to Coordinate and Streamline State and Local Taxes from those Intended Only to Restrict Them

Congress frequently considers proposals for regulating state and local tax administration. These proposals can either facilitate state and local governments' exercising their taxing authority in a fair, efficient way, or limit their taxing authority and complicate taxes in response to heavy lobbying from multistate corporations and other special interests. While some proposals to coordinate tax rules between state and local governments would ease efficient collection of taxes, many of these proposals are simply ways to restrict state and local taxes at the behest of corporations and other powerful interests. Lawmakers need to distinguish between the two.

1. Taxing the Income of Corporations and Other Businesses

When determining the extent to which a state can tax the income of a particular business under current law, the first question is whether or not the business has sufficient contacts with the state to be taxed at all (whether the business has sufficient "nexus" with the state to be taxed by it). The second question is how states allocate among themselves the income of those businesses that do have sufficient nexus to be taxed.

In the 1950s and 1960s, Congress hindered states from answering the first question in a sensible way, but nonetheless helped states answer the second question in a sensible way.

Under Public Law 86-272, enacted in 1959, Congress declared that a business selling physical goods in a state would not have sufficient "nexus" with the state to justify being taxed unless the business had a "physical presence" (generally meaning property or employees) in the state. This meant that a state could not tax a company's income if that company did not have stores or physical operations in a state but solicited orders for sales of goods to be shipped from outside the state.

This physical presence standard has done more harm than good. The so-called "Business Activity Tax Simplification Act (BATSA)" would extend the same standard to businesses with income from other types of sales (sales of services or intangible products) into a given state, and would wreak havoc on state tax collections for reasons that will be explained below.

While the 1959 act unnecessarily and restrictively defined the "nexus" a company must have in order for a state to tax its income, it left open the question of how exactly states should tax the income of those businesses that do have sufficient nexus. To explore this question, the act established a special subcommittee known as the Willis Committee that actually did help states coordinate their tax collection efforts in an efficient way.

The Willis Committee Report is an example of Congress facilitating coordinated and efficient tax collection among the states without actually enacting any federal legislation. Rather, the Willis Committee's very suggestion that Congress should enact legislation to fairly apportion business income to states based on certain factors prompted most of the states with a corporate income tax to adopt a similar proposal known as the Uniform Division of Income for Tax Purposes Act (UDITPA).[8]

The basic idea behind UDITPA is that a business with sufficient nexus with a given state will have a portion of its income taxed by that state based on the percentage of property, payroll and sales in the state. While there might be many ways, in theory, to define the proportion of income a multistate business earned in a particular state, this method is the most straightforward and fairest way. If each state adopted UDITPA and continued to follow it, then each portion of a multistate business's income would be taxed once, and only once.

In recent years, states have strayed from the basic principles behind UDITPA by altering their apportionment formula (by, for example, double-weighting the sales factor) or by replacing it entirely with a single-factor formula relying on sales alone. Many states have been convinced that companies will be more willing to locate headquarters or operations within their borders if having payroll and property in the state does not increase the percentage of the company's income subject to state taxes.[9]

This has made state tax collection more complicated, less efficient, and less fair. A company in State A might be subject to State A's corporate income tax under an apportionment formula that considers three factors (the percentage of property, payroll and sales in the state) but if State A adopts a single-factor formula based on sales, some of the company's income could escape taxation entirely.

This can happen because the company sells many of its goods to a state that does not have a corporate income tax or a state where the company does not have any physical presence, meaning it lacks the sufficient "nexus" to be taxed by that state. The possibility of such "nowhere" income (income that is not taxable in any state) is obviously very attractive to multistate corporations, which lobby states to enact single-factor formulas based on sales.[10]

It is quite ironic that one of the witnesses at the April 25 Finance Committee hearing on this topic claimed that states have strayed from the basic three-factor apportionment formula in order to "grab" income from other states. States have strayed from the three-factor formula mainly at the behest of corporations that understood this would enable their tax avoidance.[11] Congress should be very careful that any proposal to coordinate state taxes on business income move us back to the simple, straight-forward three-factor apportionment formula rather than away from that formula.

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[8] Joe Huddleston and Shirley Sicilian, "The Project to Revise UDITPA," from the Proceedings of the New York University Institute on State and Local Taxation, 2009.
http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf

[9] Institute on Taxation and Economic Policy, "Corporate Income Tax Apportionment and the 'Single Sales Factor,'" August 2011.
http://www.itepnet.org/pdf/pb11ssf.pdf

[10] Institute on Taxation and Economic Policy, "'Nowhere Income' and the Throwback Rule," August 2011.
http://www.itepnet.org/pdf/pb39throw.pdf

[11] The result, as highlighted in a December 2011 report by my organization, is that an astonishing number of Fortune 500 corporations are finding ways to avoid paying any state corporate income taxes despite being hugely profitable. See Institute on Taxation and Economic Policy and Citizens for Tax Justice, "Corporate Tax Dodging in the Fifty States, 2008-2010," December 7, 2011.
www.ctj.org/corporatetaxdodgers50states

Unfortunately, the most prominent pending legislation in this area would move the country in the wrong direction by further restricting the level of "nexus" of business must have with a state in order for its income to be taxed by that state.

This legislation is the so-called Business Activity Tax Simplification Act (BATSA), H.R. 1439. This legislation would make state and local taxes on businesses dramatically more complex, increase litigation related to business taxes, increase government interference in the market and reduce revenue to state and local governments by billions of dollars each year.[12]

Even if the "physical presence" standard made any sense, it would not matter under H.R. 1439 because it is not the standard set out in the bill. The bill has many "safe harbors" which are essentially loopholes allowing large corporations with lobbying clout to avoid state and local taxes even though they have what any rational person would call a "physical presence" in the jurisdiction.

For example, under BATSA, a company that sends a full-time worker into another state each day to install equipment could be subject to that state's taxes. However, if the company created two subsidiaries which each provided half of the equipment and which each hired the worker to perform the installations, the state would not be able to tax the business under BATSA.

The state would also be unable to tax a business if the employee was only sent into the state 14 days each year, or if the company created several subsidiaries that each hired the employee and sent him or her into the state for just 14 days each year.

If the company warehoused items in the state before shipping them to customers, one would think this constitutes "physical presence," but under BATSA it might not. Items could be warehoused in the state by a second company that ships them to customers and this second company could also be exempt from the state's business activity taxes under the exception for third-party "fulfillment" activities.

Perhaps the most outrageous abuses would occur when a company is actually based in the state in question. Such a company might create subsidiaries in other states (states without business activity taxes) and transfer trademarks and logos to them. The company would then pay royalties to those subsidiaries for the use of the trademarks and logos, and these payments would reduce or even wipe out the income reported to the state where the company is based. Most states currently have laws that allow them to tax the out-of-state subsidiaries receiving royalties in this scenario, but BATSA would nullify those laws so that this type of tax avoidance would increase dramatically.

The various intricacies of BATSA that would encourage more aggressive tax planning would naturally lead to increased litigation. Besides that, some of the safe harbors in BATSA are not defined at all, which will certainly leave state and local governments no choice but to call upon the courts to interpret the provisions of the law when companies manipulate them.

For example, even a company that has physical property and employees in a state will not have a "physical presence" there under BATSA if the property and employees are only used to carry out "limited and transient business activity," which is left undefined. It's difficult to imagine how this ambiguity would *not* lead to increased litigation.

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[12] For more details on the problems with the Business Activity Tax Simplification Act, see Michael Mazerov, "Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits And Harm the Economy," Center on Budget and Policy Priorities, updated April 13, 2011. http://www.cbpp.org/cms/index.cfm?fa=view&id=424

Perhaps some lawmakers may comfort themselves with the notion that despite all of these problems, in the end BATSA will mean the government has a lighter hand in the economy because businesses will be taxed by fewer state and local governments.

To the contrary, BATSA is the ultimate example of government picking "winners and losers" among businesses competing against each other. BATSA would create artificial advantages for very large, multi-state companies that conduct most of their business online or over the phone and which have the resources to engage in the type of tax avoidance schemes already described.

2. Requiring Businesses to Collect Sales Taxes on Interstate Sales

Whereas the previous section of this testimony addressed the extent to which a state can tax a multistate business's income, another question is the extent to which a state can require a multistate business to collect sales taxes. This question has nothing to do with taxes on the business's income, but merely asks whether or not the business must take the administrative step of collecting sales taxes that its customers are required to pay.

In a jurisdiction that imposes a sales tax, a business that sells a product from a physical store is required to collect the sales tax from the buyer. The sales tax is not paid by the seller but by the buyer, whose total purchase price includes the sales tax as well as the underlying retail price of the product. The business that sells the product is merely required to collect the tax and pass it on to the state or local government.

However, when a person in the state buys a product online, the state is often unable to require the business selling the product to collect the sales tax because the business does not have a physical presence in the state. This level of "nexus" (the connection that a business must have with a state before the state can require it to collect sales taxes) was imposed not by Congress but by the U.S. Supreme Court's interpretation of the Commerce Clause in a 1992 decision.[13]

Under the Supreme Court's decision, Congress can decide to grant the states the authority to require out-of-state businesses to collect sales taxes on sales into their jurisdictions. This would make it far easier for state and local governments to adapt to the internet age.

The question is not whether or not sales taxes should be imposed, but who has responsibility for collecting them and delivering them to the state or local government. In states with sales taxes, internet purchases (and other purchases from out-of-state businesses) are subject to the sales tax, but the buyers themselves are required to calculate the sales tax and send it to the state or local government. (In these cases the tax is technically called a "use tax.") But these rules are unenforceable. Needless to say, almost no one who buys a product from Amazon thinks to calculate their sales taxes and send a payment to their state or local government.

A bill before Congress would allow states to require internet sellers and other out-of-state sellers to collect sales taxes in return for states simplifying their sales taxes. The legislation, the Marketplace Fairness Act, S. 1832, is an example of a federal proposal that really would help states coordinate their tax rules and collect revenue in a more efficient way. In order to benefit from the law, states would be required to conform their sales tax laws to the Streamlined Sales and Use Tax Agreement (SSUTA) (which was forged by representatives of several states to harmonize sales tax rules) or take other steps to simplify their sales taxes.

Currently twenty states are full members of SSUTA and four states have "associate member" status, meaning they are on their way to becoming full members. SSUTA does not restrict member states' power to set their own sales tax rates

[13] *Quill Corporation v. North Dakota* (U.S. 1992).

or even their power to determine the base of their sales tax (which sales are subject to the sales tax) but requires them to use uniform definitions to define the sales tax base. This addresses the complexity that motivated the Supreme Court's 1992 decision — the complexity that would otherwise be faced by multistate business with sales in several jurisdictions with different sales tax rules.[14]

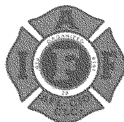
New technology, combined with the harmonized sales tax rules under SSUTA, would make it relatively easy for internet retailers to determine what sale taxes apply in a customer's jurisdiction. We know this because major retailers that have a "physical presence" in numerous states, like Best Buy and Barnes and Noble, already collect sales taxes on sales made over the internet, in addition to those made inside their physical stores. Similarly, Amazon collects sales tax on behalf of a huge number of merchants located all around the country that sell via its website, though it mostly refuses to do so on items it sells directly. Netflix's CEO summed up the reality of the tax complexity problem when he said, "We collect and provide to each of the states the correct sales tax. There are vendors that specialize in this... It's not very hard."[15]

Opponents of the Marketplace Fairness Act have incorrectly labeled it a tax hike. The bill doesn't actually create a new tax, nor does it raise an existing one. Rather, it merely creates a mechanism to collect taxes that have always been owed.

Failing to collect these taxes creates two major problems. First, states are losing out on badly needed revenue. Second, traditional brick and mortar stores are at a competitive disadvantage when their customers have to pay a tax that online shoppers are able to evade. There is no reason for large online retailers like Amazon to have this sort of competitive advantage — which exists only because of tax law — over businesses that operate in traditional, physical stores.

As an extreme example of this second problem, in many instances customers will go so far as to examine and "try out" merchandise at stores, only to return home and purchase the same product online in order to evade their sales tax responsibility. It's no surprise then that numerous organizations representing retail owners, such as the Retail Industry Leaders Association (RILA), support the bill.[16]

[14] Institute on Taxation and Economic Policy, "How Can States Collect Taxes Owed on Internet Sales?" July 2011. http://www.itepnet.org/pdf/pb2quill.pdf
[15] Id.
[16] Joint Statement of Senators Michael B. Enzi, Richard J. Durbin, Lamar Alexander, Tim Johnson, John Boozman, Jack Reed, Roy Blunt, Sheldon Whitehouse, Bob Corker, Mark Pryor for Hearing: Tax Reform: What It Means for State and Local Tax and Fiscal Policy, April 25, 2012.



INTERNATIONAL ASSOCIATION OF FIRE FIGHTERS®

HAROLD A. SCHAITBERGER
General President

THOMAS H. MILLER
General Secretary-Treasurer

Statement of

Harold A. Schaitberger
General President
International Association of Fire Fighters

Hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

Before the

Senate Finance Committee

April 25, 2012

1750 NEW YORK AVENUE, N.W., WASHINGTON, D.C. 20006-5395 • (202) 737-8484 • FAX (202) 737-8418 • WWW.IAFF.ORG

Introduction

Chairman Baucus, Ranking Member Hatch, and all the distinguished Senators on this committee, I would like to thank you for holding this important hearing on how tax reform will impact state and local governments. As the General President of the International Association of Fire Fighters (IAFF), I speak today on behalf of the nearly 300,000 men and women who risk their lives to provide fire, rescue and emergency medical services protection to over 85 percent of our nation's population.

Although IAFF members are committed first and foremost to protecting their communities, they are not immune to the fiscal challenges posed by these difficult economic times. As employees of state and local governments, their livelihoods and their ability to respond effectively to the next house fire or the next heart attack is linked to the budget shortfalls facing far too many governmental jurisdictions.

The stark reality is that the Great Recession has decimated state and local government budgets. According to the Center on Budget and Policy Priorities, state and local governments have closed shortfalls amounting to over $530 billion over the last four years. Despite an improving economic outlook, budget shortfalls still persist. Thirty states have either projected shortfalls or have accounted for shortfalls that total $49 billion for FY2013. Without additional revenue to balance their budgets, states and local governments will be forced to cut back on essential services, possibly leading to layoffs, station closings and brownouts for the fire service. Additional cuts to the fire service will only exacerbate the dire jobs picture for state and local governments. Since 2009, 611,000 public sector jobs have been lost as a result of the Great Recession.

That is why today's hearing is so important. As this distinguished committee weighs comprehensive tax reform, it should not overlook tax issues important and unique to state and local governments. In some instances, such as S. 1832, the "Marketplace Fairness Act," this committee could act to make sales tax policy more equitable while improving revenue streams for state and local governments, and it could do so independent of tax reform. Alternatively, this committee could enact policies that would harm the fiscal outlook for state and local governments by eliminating or capping the deductibility of state and local taxes, eliminating tax-exempt bonds, or by passing federal bills that would preempt the sovereign taxing authority of state and local governments. Therefore, I respectfully request that this committee first pass the "Marketplace Fairness Act," and second do no harm to state and local governments.

S. 1832, the "Marketplace Fairness Act"

Throughout the nation, reduced revenue is forcing states and local governments to undertake drastic measures to balance their budgets. Despite modest improvements in the past two years, revenues for state and local governments remain at historic lows. As of the third quarter of 2011, state revenues were still 7 percent less than when the Great Recession began. According to the

Center on Budget and Policy Priorities, this budget hole is so great that even with a robust 8 percent rate of growth, it would take 7 years to get back on track.

One factor contributing to budget shortfalls both at the state and local level is the dramatic increase of online sales. Many e-retailers are not required to charge sales and use taxes because they do not have a physical presence in the state where the purchase is made. This special tax preference gives e-retailers an unfair competitive advantage over traditional "brick and mortar" businesses, which must charge sales taxes on every item sold, from a pack of gum to a new car.

As more consumers have chosen to buy goods and services online, total sales tax receipts for state and local governments have plummeted. A recent University of Tennessee study found that state and local governments are losing $23 billion each year due to e-commerce. In addition, property tax receipts, which help fund municipal fire departments and school districts, have also been affected as more brick and mortar stores go out of business due to the unfair competition from out-of-state e-retailers.

To address this problem, Congress should pass S. 1832, the "Marketplace Fairness Act." This bipartisan legislation would allow local main street retailers to compete more effectively against out-of-state e-retailers, give states the ability to enforce their own sales and use tax laws, relieve consumers of the legal burden to report to state tax departments the sales and use taxes they owe for online purchases, and help governors and mayors collect taxes already owed, reducing the need to raise new taxes.

Importantly, this bill does not create new taxes or increase existing taxes. Under current law, consumers living in states with a sales tax are required to remit use taxes for online purchases. Compliance with the law is poor, because most consumers are unaware of their tax obligations. The "Marketplace Fairness Act" simply gives states a way to enforce existing sales and use tax laws while eliminating the competitive advantage currently enjoyed by remote retailers at the expense of local businesses. For states without a sales tax, nothing would change. The "Marketplace Fairness Act" does not require a state to adopt a sales tax. That decision will still rest with the citizens of each state.

In addition to bipartisan support in Congress, a large coalition of organizations has formed to urge passage of the "Marketplace Fairness Act." Government representatives such as the National Governors Association and the U.S. Conference of Mayors, business groups such as the National Retail Federation and the International Council of Shopping Centers, Fortune 500 companies such as Amazon and Best Buy, and labor unions all support this important legislation. At a time when business and labor are often at odds, I hope that this committee, which is famous for finding bipartisan solutions to our great nation's problems, will take special note of this unique coalition.

Finally, I urge this committee to pass the "Marketplace Fairness Act" separately from comprehensive tax reform. Any effort to fundamentally reshape the United States tax code will

be a Herculean task for this Congress or future Congresses. But the fire stations facing closures due to budget shortfalls cannot wait until there is a filibuster-proof majority in support of a broad tax plan, just as the mom-and-pop store on Main Street cannot wait for a conference committee report to be filed. This commonsense and bipartisan legislation deserves consideration in this Congress, in this session.

Federal Preemption

The second dynamic that could hinder the ability of states and localities to continue generating revenue is a series of federal bills that directly usurp the sovereign rights of state and local governments to impose certain taxes. These initiatives, which are often championed by legislators who otherwise support federalism and states' rights, would potentially cost states billions of dollars by preempting existing state and local taxes.

In addition to the loss of revenue, proposals to restrict states taxing authority trample on the rights of states and local governments to establish policies that address the specific needs of their citizens. Although tax laws can vary from jurisdiction to jurisdiction, they reflect the decisions of a democratically elected government. The federal government should not preempt the will of the people by imposing one-size-fits-all solutions from Washington.

The IAFF urges this committee to oppose the following bills:

- H.R. 1439, the "Business Activity Tax Simplification Act," would allow large businesses and corporations to avoid paying taxes to states and localities. For the first time ever, states and localities would be prohibited from imposing existing taxes on legitimate business activity by creating a new physical presence rule, which would significantly weaken the current "economic nexus" standard. As a result, H.R. 1439 would limit state and local governments from keeping their own tax systems, and would reward large profitable corporations for making business decisions designed to aggressively avoid taxes. The Congressional Budget Office has determined that H.R. 1439 would be an unfunded mandate on state and local governments, costing $2 billion in the first full year after enactment.

- H.R. 1002/S.543, the "Wireless Tax Fairness Act," would prohibit for five years state and local governments from raising additional revenue on cell phone services. Specifically, the bill would prohibit state and local governments from imposing certain new taxes on providers of wireless communications service for five years after enactment of the legislation. States and local governments are still struggling to balance their budgets even as the economy slowly recovers. A new federal mandate restricting their ability to raise additional revenue would fail to take into account that state and local tax systems vary greatly among jurisdictions, taxing goods and services at different rates to meet the specific needs of its citizens. The federal government should not be dictating to sovereign state and local governments how best to meet those needs.

- H.R. 1864, the "Mobile Workforce State Income Tax Simplification Act," would restrict states from taxing income earned while working in that state. Specifically, it would prohibit every state government from taxing the income earned in that state of an individual residing in another state, if that non-resident works less than 30 days in the state seeking to impose the tax. H.R. 1864 ignores the reality that state tax systems are autonomous and differ from state to state. It would unfairly impose a one-size-fits-all federal mandate on states and could open the door to subsequent legislation restricting local governments as well. CBO estimates H.R. 1864 will lead to revenue losses in a number of states, including California, Illinois, and Massachusetts. New York state estimates that it would lose between $95 million and $115 million starting in 2013.

- H.R. 2469, the "End Discriminatory State Taxes for Automobile Renters Act," would ban state and local governments from applying certain types of taxes on car rentals. Specifically, the bill would seek to ban so-called "discriminatory" taxes on car rentals or car rental companies without any regard to the factors that state and local governments use to determine the specific needs of their constituents. For example, Revere, Massachusetts used revenue from rental car taxes to build police and fire stations, and Arlington County, Virginia uses revenue from car rental taxes to help pay for police, fire fighter and emergency medical services to Reagan National Airport, the Pentagon, Arlington National Cemetery, and other popular tourist destinations. The federal government should not undermine these local decisions with a blanket, one-size-fits-all mandate.

- S. 871/H.R. 1860, the "Digital Goods and Services Tax Fairness Act of 2011," would regulate state and local governments taxing authority of downloaded music, movies and online services. Proponents of the legislation argue that it would protect consumers from discriminatory or multiple taxes on e-commerce. But existing law already provides these protections. The "Internet Tax Freedom Act" currently bans "multiple or discriminatory taxes on electronic commerce," with a definition of "electronic commerce" sufficiently broad as to encompass all digital goods and services. As a result, the actual occurrence of multiple taxes on a single digital good or service is rare beyond hypothetical examples cited by the bill's proponents. Furthermore, unlike other federal preemption bills that are prospective, S. 871/H.R. 1860 is retroactive, banning tax laws that were passed by democratically elected state governments. Considering the lack of actual harm caused by the alleged problem, it is shocking that the bill would adopt such a far-reaching and unprecedented assault on the taxing authority of state and local governments.

State and Local Tax Deductions

Since the inception of the modern income tax in 1913, taxpayers have been able to deduct state and local taxes in some form from their federal tax liability. Over the years, Congress enacted certain amendments to the "taxes-paid" deduction, such as the elimination of sin taxes in 1964, motor fuel taxes in 1978, and general sales taxes in 1986. But Congress has repeatedly preserved the taxes-paid deduction as a fundamental part of our tax system, and for good reason.

The taxes-paid deduction underscores a basic premise that one's tax liability should be based on one's ability to pay. Eliminating the taxes-paid deduction would change this premise by instituting a federal tax on income already lost through the payment of state and local taxes. In other words, it would amount to the federal government double-taxing its citizens. I am not a professional pollster, but I would imagine that avoiding a double-tax on the American public is one reason why the taxes-paid deduction has withstood the test of time.

I am, however, a former employee of a municipal government, and I can attest to the benefits that the taxes-paid deduction provides. Numerous studies have shown that removing the taxes-paid deduction would reduce services funded by state and local governments. The fire service certainly is not immune to this threat with a majority of our funds coming from property taxes, which are deductible from federal taxes. Any change to the taxes-paid deduction could result in a diminished fire service.

I would also like to point out that the fire service provides benefits that extend beyond the immediate taxing locality. Especially since 9/11, the fire service has taken on an expanded role, serving as our nation's domestic responders to a wide array of regional and national threats. From wildfires, floods, tornadoes, and terrorist attacks, the fire service repeatedly responds to large-scale threats while simultaneously serving its core function as its community's first responders. By reducing the financial impact of state and local taxes, the taxes-paid deduction allows the fire service to meet both its local and national objectives. Whether you are a resident of Montana, Utah, or Maryland, all residents benefit when the fire service is adequately staffed and funded. Consequently, I respectfully request that the committee maintain the current deduction for state and local taxes.

Tax-Exempt Governmental Bonds

Under present law, state and local governments can issue bonds that produce tax-exempt interest for the investor. This tax preference allows state and local governments to maintain lower borrowing costs because investors are willing to accept interest rates that are lower than with taxable bonds. Recent proposals such as the Simpson-Bowles Commission called for the elimination of the tax-exempt status for all new bonds. Other proposals would call for replacing the tax-exempt status with a direct federal subsidy or tax credit to borrowers.

The IAFF urges this committee to leave intact the current exemption for state and municipal bonds. For decades, these bonds have helped state and local governments fund critical infrastructure projects, including new roads, bridges, water systems, and schools. Particularly at a time when the economy is still struggling to recover from the worst recession since the Great Depression, the federal government should be searching for ways to boost the construction trades, not depress them.

Higher borrowing costs will have disastrous consequences for state and local governments. Bond issuers will face greater uncertainty when setting higher interest rates. In addition, higher

borrowing costs will lead to either reducing the size and scope of new infrastructure projects, burdensome new taxes, or both.

Conclusion

On behalf of the IAFF, I would like to thank the distinguished chairman and ranking member for holding this important hearing on state and local tax issues. As you proceed with the difficult task of passing comprehensive tax reform, I would urge you to keep in mind the views of the IAFF. Our members' ability respond swiftly to any and all threats to our great country hinges on the most fundamental compact between the individual and society; that is, the ability to raise revenue to fund essential government services. In this regard, I urge you to pass S. 1832, the "Marketplace Fairness Act," and to do so independent of tax reform. In addition, I urge you to reject any bills that would preempt the sovereign taxing authority of state and local governments, and to preserve the current deductions for state and local taxes and tax-exempt bonds.

International City/County Management Association
National Association of Counties
National League of Cities
U.S. Conference of Mayors
Government Finance Officers Association
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
American Public Gas Association
American Public Power Association
Council of Development Finance Agencies
Council of Infrastructure Financing Authorities
Education Finance Council
International Municipal Lawyers Association
Large Public Power Council
National Association of College and University Business Officers
National Association of Health & Higher Education Facilities Authorities
National Association of Local Housing Finance Agencies
National Association of School Administrators
National Council of State Housing Agencies
National School Boards Association
Bond Dealers of America
Investment Company Institute
National Association of Bond Lawyers
National Association of Independent Public Finance Advisors
Securities Industry and Financial Markets Association

April 23, 2012

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch:

The state and local government associations and other organizations listed above representing participants involved in the municipal bond market, commend you for holding a hearing on the impact of tax reform proposals on state and local governments. Our associations look forward to testifying in future hearings as government representatives and market participants. This submission is limited to a discussion of the importance of tax-exempt bonds. We urge Congress' continuing support and commitment to tax-exempt bond financing in recognition of the critical role it plays in the ability of state and local governments to fund national priorities, particularly infrastructure.

Maintaining the tax-exempt status ofmunicipal bonds is essential to help our national economy grow, create jobs, and best serve the constituencies of every community. Three-quarters of the total United States investment in infrastructure is provided by state and local governments, and tax-exempt bonds are the primary financing tool used by over 50,000 state and local governments to accomplish these infrastructure goals.

Our citizens and communities benefit in many ways from the issuance of tax-exempt bonds. They are used to build and maintain elementary and secondary schools, as well as colleges and universities, which help develop an educated workforce. They are used to build our roads and airports, all of which are essential for supporting commerce. They address the country's water infrastructure, electric utility and affordable housing needs. Tax-exempt bonds also finance public safety infrastructure that ensures local and national security. Nearly four million miles of roadways, 500,000 bridges, 1,000 mass transit systems, 16,000 airports, 25,000 miles of intercoastal waterways, 70,000 dams, 900,000 miles of pipe in water systems, and 15,000 waste water treatment plants have been financed through municipal bonds. (National League of Cities)

States and localities determine if bonds should be issued to meet the needs of their citizens, generally through a vote by elected officials or through voter referenda. Placing the decision-making at the state and local levels ensures effective resource allocation and avoids inefficient decisions due to federal bureaucracy, cumbersome grant programs, earmarking and similar processes. An extensive federal legislative and regulatory regime exists under the Internal Revenue Code to ensure that tax-exempt bonds are used properly.

State and local governmental bonds have been issued since the mid-1800s, and the federal tax exemption was included in the country's income tax code since its promulgation in 1913. Through the tax-exemption, the federal government continues to provide critical support for the development and maintenance of essential facilities and services, which it cannot practically replicate by other means. Without the tax-exemption, state and local governments would pay more to raise capital, a cost that ultimately would be borne by taxpayers, through reduced infrastructure spending, decreased economic development, higher taxes or higher user fees.

The ability to sell bonds with interest exempt from federal income taxes reduces the interest paid for borrowed funds by approximately 25 percent (SIFMA). Tax-exempt bond issuance has remained stable compared to GDP over the past 10 years, averaging around 14.8%, and has actually declined since the 1980s. State and local governments are not overextended in debt. In fact, debt service is typically only about 5% of the general fund budgets of state and municipal governments. The tax-exemption represents a fair allocation of the cost of projects between the federal and state/local levels of government. State and local borrowers are responsible for repaying the principal and interest on a bond. The federal contribution is provided in the form of theoretically foregone tax revenue and represents an important, but relatively small portion of total project costs. As a result, the federal contribution is significantly leveraged.

Municipal bonds offer a healthy investment for American families in America's communities. Seventy percent of municipal bonds are held by individuals, directly or through mutual funds (Thompsen Reuters). Investors choose to purchase municipal bonds, even though the investment return is less than if they purchased corporate or other taxable bonds, because the tax-exemption results in an equivalent after-tax benefit. Furthermore, as a class of investment, all investment grades of municipal bonds have proven to be safer investments than AAA corporate bonds (Municipal Market Advisors).

Our experience informs that tax-exempt financing is a well-established market providing a cost-effective mechanism for financing infrastructure and meeting needs of our citizens. Any changes that would replace, compromise, dampen or eliminate tax-exempt financing immediately or retroactively, particularly those offered as deficit reduction alternatives, should be carefully and cautiously analyzed by the committee.

Thank you again for the opportunity to comment on this important issue. We look forward to continuing conversations with you and your staff about these important issues.

Sincerely,

International City/County Management Association, Elizabeth Kellar, 202-289-4262
National Association of Counties, Michael Belarmino, 202-942-4254
National League of Cities, Lars Etzkorn, 202-626-3173
U.S. Conference of Mayors, Larry Jones, 202-861-6709
Government Finance Officers Association, Susan Gaffney, 202-393-8468
National Assn of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou, 202-624-5451
National Association of State Treasurers, Jon Lawniczak, 859-244-8175
American Public Gas Association, Dave Schryver, 202-464-0835
American Public Power Association, Joy Ditto, 202.467.2954
Council of Development Finance Agencies, Toby Rittner, 614-224-1300
Council of Infrastructure Financing Authorities, Rick Farrell, 202-547-1866
Education Finance Council, Vince Sampson, 202-955-5510
International Municipal Lawyers Association, Chuck Thompson, 202-742-1016
Large Public Power Council, Noreen Roche-Carter, 916-732-6509
National Association of College and University Business Officers, Liz Clark, 202-861-2553
National Assn of Health & Higher Education Facilities Authorities, Chuck Samuels, 202-434-7311
National Association of Local Housing Finance Agencies, John Murphy, 202-367-1197
National Association of School Administrators, Bruce Hunter, 703-875-0738
National Council of State Housing Agencies, Garth Riemen, 202-624-7710
National School Boards Association, Deborah Rigsby, 703-838-6208
Bond Dealers of America, Mike Nicholas, 202-204-7901
Investment Company Institute, Jane Heinrichs, 202-371-5410
National Association of Bond Lawyers, Bill Daly, 202-503-3303
National Association of Independent Public Finance Advisors, Colette Irwin-Knott, 317-465-1504
Securities Industry and Financial Markets Association, Michael Decker, 202-962-7430

cc: All members of Senate Committee on Finance

April 24, 2012

Honorable Max Baucus, Chairman
Honorable Orrin Hatch, Ranking Member
United States Senate, Committee on Finance
Attn: Editorial and Document Section
Room SD-210
Dirksen Senate Office Building
Washington, DC 20510-6200

RE: April 25 Senate Finance Committee Hearing on *Tax Reform: What it Means for State and Local Tax and Fiscal Policy*

Dear Chairman Baucus, Ranking Member Hatch and Members of the Committee

As the Senate Finance Committee prepares to hear testimony on federal tax reform as it relates to state and local tax policy, the International Franchise Association urges you to support business activity tax nexus reform.

Effective reform of the business activity tax nexus would establish a bright-line rule that all states would follow by codifying the traditional physical presence governing state imposition of corporate income tax and comparable business activity taxes. The legislation is consistent with the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota* (1992), which justified the prohibition of states forcing out-of-state corporations to collect certain taxes unless it established a physical presence in the taxing state.

Despite the Court's rulings, states desperate for revenue have attempted to collect corporate income and other taxes from franchise companies because of a vague "economic presence" standard, which can include intangibles such as trademarks, trade names, intellectual property or advertising. As part of franchise agreements franchisors and franchisees share trademarks and brands, forcing franchise companies to pay millions of dollars in back taxes to states in which they do not own or operate a single location.

Differences in tax nexus policies from state to state add to the debilitating uncertainty for our nation's job creators in this still challenging economic recovery. BATSA would ensure that a single standard of taxation applies for taxing multi-state companies, such as most franchisors, taking some of the confusion out of interstate commerce. We urge the Senate to take up legislation similar to H.R. 1439, the Business Activity Tax Simplification Act ("BATSA"), a bipartisan bill sponsored by

Reps. Goodlatte (R-VA) and Scott (D-VA) in the U.S. House of Representatives, that would clarify this troubling inconsistency in state taxation, protect American businesses from over-reaching tax collections and litigation, and promote certainty in the business environment.

Sincerely,

Jay Perron
Vice President, Government Relations & Public Policy
International Franchise Association

The Large Public Power Council

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www.lppc.org

Statement of Large Public Power Council

United States Senate
Committee on Finance
Hearing on
"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"
April 25, 2012

Austin Energy (TX) • Chelan County PUD (WA) • Clark Public Utilities (WA) • Colorado Springs Utilities (CO) • CPS Energy (TX)
ElectriCities of North Carolina, Inc. (NC) • Grant County PUD (WA) • IID (CA) • JEA (FL) • Long Island Power Authority (NY)
Los Angeles Department of Water and Power (CA) • Lower Colorado River Authority (TX) • MEAG Power (GA) • Nebraska Public Power District (NE)
New York Power Authority (NY) • Omaha Public Power District (NE) • OUC (FL) • Platte River Power Authority (CO)
Puerto Rico Electric Power Authority (PR)) • Sacramento Municipal Utility District (CA) • Salt River Project (AZ) • Santee Cooper (SC)
Seattle City Light (WA) • Snohomish County PUD (WA) • Tacoma Public Utilities (WA)

Chairman Baucus, Ranking Member Hatch and members of the Committee. Thank you for the opportunity to submit testimony for the record on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy." As your Committee continues its examination of comprehensive tax reform, it is critical that the Committee carefully consider the importance of tax-exempt financing to state and local governments, including public power systems. For nearly a century, tax-exempt financing has allowed governmental entities to invest in essential infrastructure in a cost-effective manner, including roads and schools for cities and counties, and generation and transmission facilities for public power systems.

Proposals that would restrict, means-test or eliminate the longstanding federal income tax exemption for interest from municipal bonds will increase the cost of providing governmental services, with the burden ultimately shouldered by taxpayers in already hard-pressed communities throughout the country. In addition, proposals to substitute the tax credit bond or subsidized taxable bond mechanisms for tax-exempt financing, rather than complement it, are also flawed because, as we discuss in detail below, past experience with programs such as Clean Energy Renewable Bonds and Build America Bonds has demonstrated that not all state and local entities can utilize this tool efficiently, nor have the financial markets developed to fully deal with these new instruments.

Large Public Power Council

Public power utilities are locally owned and controlled, not-for-profit power systems that serve more than 46 million people in 49 of our 50 states, or about 14 percent of the nation's electricity consumers. The Large Public Power Council (LPPC) is an organization comprised of 25 of the largest of these systems. Members are located in 11 states and Puerto Rico, and provide reliable, low-cost electricity to some of the largest communities in the country, including Los Angeles, Seattle, New York, Omaha, Phoenix, Sacramento, San Antonio, Jacksonville, Orlando and Austin. LPPC member utilities own and operate more than 86,000 megawatts of generation capacity and over 35,000 circuit miles of high voltage transmission lines.

Importance of Tax-Exempt Financing

Since the first federal tax laws were enacted, state and local governments (which by definition own and operate public power systems) have had the ability to utilize federally tax-exempt financing. Governmental entities have limited means to raise funds for their communities' capital needs. They cannot sell stock and so are permitted to raise capital by issuing federally

tax-exempt bonds, which carry lower interest rates that are fully passed through to reduce the cost of governmental services such as the building of roads, schools, and public safety infrastructure. Public power systems use tax-exempt bonds to finance their electric generation, transmission, and distribution assets, as well as related facilities. Given the capital-intensive nature and long-lived assets of an electric utility, tax-exempt debt is essential to operating a viable public power system.

Public power systems borrow on a long-term basis to finance their long-lived assets. The only sensible means of funding an electric generation or transmission project that can cost hundreds of millions or even billions of dollars and that has a 40 or 50 year life is to borrow all or much of the cost of the project and spread the cost over its useful life. The cost is then shared by all the customers that will benefit from the project.

State and local governments, and ultimately their citizens, average an estimated two percentage point savings by using tax-exempt debt to finance investment in public infrastructure. Over the past few decades, tax-exempt finance has generated trillions of dollars of investment in vital public infrastructure and has saved state and local governments hundreds of billions of dollars in interest costs.

Overview and Regulation of the Tax-Exempt Bond Market

The tax-exempt bonds market currently is a $3.7 trillion market, and consists of over 50,000 issuers. According to Moody's and Fitch Ratings, the historical default rate in the entire municipal sector is substantially below the corporate default rate at less than 1/3 of 1%. In fact, since 1970 over two-thirds of this small percentage of defaults has been related to debt issued by special entities for healthcare and housing projects, and very few from public power systems, cities, counties.

There is a longstanding and comprehensive federal legislative and regulatory system in place to regulate the tax-exempt bond market. Federal tax laws significantly limit the purposes for which tax-exempt bonds may be issued and the investment of tax-exempt bond proceeds. These rules are particularly restrictive for public power systems. For example, in the case of public power bond issuances, regardless of the size of the borrowing, no more than $15 million (or 10% of the total, if less than $15 million) of the proceeds can benefit entities that are determined to constitute private use. Furthermore, the IRS "private use rules" effectively prevent issuers

from using tax-exempt bonds to build larger facilities than are required to meet the needs of their communities or to issue bonds with longer terms than needed. In combination, these rules ensure that tax-exempt bonds are used for legitimate governmental purposes.

The SEC and Municipal Securities Rulemaking Board regulate the manner in which state and local governments may sell their bonds and provide rules on the types of disclosure required in connection with the sale of municipal bonds, as well as ongoing annual and material event disclosure. Both the IRS and SEC have active enforcement programs for state and local bonds to help ensure that the applicable rules are satisfied.

Implications of Elimination or Replacement of State and Local Interest Exclusion

Some claim that tax-exempt bonds are an inefficient method of reducing the borrowing costs of State and local governments and suggest that tax credit bonds or other forms of subsidy are a better alternative. These claims ignore the fact that, despite numerous efforts at creating workable tax credit bond programs, there is no viable replacement to the $3.7 trillion tax-exempt bond market. The tax credit bond programs created in recent years as alternatives to tax-exempt bonds have had little acceptance among investors, and the prices that investors have been willing to pay have resulted in tax credit bonds having their own inefficiencies. Given the lack of substantial investor interest in tax credit bonds, it is simply not credible to expect that tens of billions of dollars in tax credit bonds could be issued each year without creating inefficiencies that exceed the purported inefficiencies of tax-exempt bonds.

The most effective alternative to tax-exempt bonds—Build America Bonds—was not a tax credit bond. It was a direct cash payment by the federal government to the issuers of these bonds, rather than a tax credit to investors. It was, in contrast to the tax credit bond programs, a highly successful program. However, its success was largely the result of the program providing a level of subsidy that exceeded that provided by tax-exempt bonds. Further, while Build America Bonds are an excellent complement to tax-exempt bonds, they are not an alternative since the taxable bond market is simply not equipped to deal with the tens of thousands of State and local governments of all shapes and sizes that routinely participate in the municipal bond market, with the result that many local governments would be shut out of the bond market and forced to pay higher interest rates.

Implications of Limitation on Deducibility of Tax-Exempt Interest

President Obama's budget proposal released on February 13, 2012 included a provision that would impose tax on interest on municipal bonds owned by certain high-income earners. Late last year, the President's Jobs Act and Deficit Reduction Plan included similar provisions to offset spending and reduce federal deficits. Similarly, Chairman Baucus in his opening statement for this hearing suggested that all investors in tax-exempt bonds could receive a "uniform subsidy," regardless of differing marginal tax rates.

LPPC has strong concerns with these proposals. It is critical to understand that any tax on investors in tax-exempt bonds (or other reduction in investor benefits from tax-exempt bonds) is, in reality, a tax on the issuers of those bonds. This is because Investors in municipal bonds will demand higher yields to make up for the lost benefit and uncertain tax treatment. Moreover, the Administration's proposal would be retroactive to already-issued bonds—an unprecedented and unfair effective date for a proposal applicable to municipal bonds.

LPPC sent your Committee a letter in opposition to this provision in the President's budget, which is attached to this testimony for your reference.

Industry analysts have projected that enactment of the Administration's proposal to cap deductibility of municipal bond interest at 28% could increase interest rates .4 to .75%, depending on a number of variables. The increase would be primarily caused by the higher rates demanded by investors to offset their tax increase and to reflect added uncertainty about future tax treatment. Over the last 10 years, public power has averaged approximately $20 billion in new bond issuances each year, with an average term 20 years. Based on these figures, an increase in rates between .4 and .75% would translate into an additional $1.6 - $3 billion in borrowing costs paid by public power customers over the life of a single years issuance of bonds. Since this increase would be perpetually added to annual bond issuances going forward as public power continues to invest in infrastructure, the cumulative impact after 10 years could be $15-$30 billion of additional annual debt service payments. While this impact is clearly significant to public power customers, it is important to note that this is only a fraction of the overall market and the impact to all other state and local governments would be substantially larger.

Conclusion

Chairman Baucus and members of the Committee, thank you again for the time and attention you and your staff have dedicated to examining the implications of tax reform on state and local tax and fiscal policy.

As the Finance Committee continues its work on issues related to tax reform, LPPC reiterates its firmly held position that proposals that restrict, means-test or eliminate the longstanding federal income tax exemption for interest from municipal bonds will increase the cost of providing governmental services, with the burden ultimately shouldered by taxpayers in already hard-pressed communities throughout the country.

The tax-exempt bonds market is a $3.7 trillion market with an extremely small default rate that is critical to the funding of state and local infrastructure projects. Without it, state and local governments will be faced with higher borrowing costs that jeopardize their abilities to meet the increasing needs of their populations, potentially resulting in additional federal assistance.

We urge the Committee to preserve current law treatment of tax exempt financing and to consider proposals such as tax credit bonds and subsidized taxable bond mechanisms as opportunities to complement, not substitute, its nearly century long place in our federal tax law.

Attachment: LPPC February 13, 2012 letter to Chairman Baucus and Ranking Member Hatch

The Large Public Power Council

www.lppc.org

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February 13th, 2012

The Honorable Max Baucus
United States Senate
511 Hart Senate Office Building
Washington, D.C. 20515

The Honorable Orrin Hatch
United States Senate
104 Hart Senate Office Building
Washington, D.C. 20515

Dear Chairman Baucus and Ranking Member Hatch:

The Large Public Power Council, representing 25 of the largest publicly-owned electric utilities in the United States,* would like to express its strong opposition to a provision in the President's FY 2013 budget proposal that would impose tax on the interest received on municipal bonds owned by certain high-income earners. While intended to limit the benefit of the municipal bond interest exemption for higher-income taxpayers, the President's proposal actually would be a tax, not on high-income investors, but on state and local governments and other municipal entities, including publicly-owned electric utilities. This is because investors will continue to invest in municipal bonds, but demand a higher interest rate to make up for the new tax.

The net result of the President's proposal is a substantial increase in interest rates on municipal bonds and higher costs for investments in essential infrastructure. As you know, state and local governmental entities are not able to issue stock; their only access to the capital markets to finance infrastructure projects is through the municipal bond market. Any proposal that places an additional burden on investors in that market directly translates into additional financing costs for municipalities. As not-for-profit entities, these additional costs are ultimately passed through its citizens, including publicly-owned utility customers. Moreover, this provision would be applied retroactively to already-issued bonds—an unprecedented and unfair effective date for issuers of municipal bonds that creates uncertainty and could increase borrowing costs long before the legislation is even considered.

We urge you to reject this proposal resoundingly. As publicly-owned utilities, we, like other municipal entities, are struggling to provide affordable and reliable services to our customers in the face of the most difficult economy since the Great Depression. Proposals such as the President's will only serve to increase the already-heavy economic burden on working families.

Sincerely,

Brian H. Moeck
Chair

*The Large Public Power Council represents 25 of the largest locally owned and operated not-for-profit electric systems in the nation. Members are located in 11 states and Puerto Rico. LPPC member utilities supply electricity to some of the largest communities in the country -- including Los Angeles, Seattle, New York, Omaha, Phoenix, Sacramento, Jacksonville, San Antonio, Orlando and Austin.

The Large Public Power Council

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cc:
The Honorable Harry Reid, Majority Leader
United States Senate

The Honorable Mitch McConnell, Minority Leader
United States Senate

The Honorable John Boehner, Speaker of the House
United States House of Representatives

The Honorable Nancy Pelosi, Democratic Minority Leader
United States House of Representatives

The Honorable Kent Conrad, Chairman
Senate Budget Committee

The Honorable Jeff Sessions, Ranking Member
Senate Budget Committee

The Honorable Dave Camp, Chairman
House Ways and Means Committee

The Honorable Sander Levin, Ranking Member
House Ways and Means Committee

The Honorable Paul Ryan, Chairman
House Budget Committee

The Honorable Chris Van Hollen, Ranking Member
House Budget Committee

William O. Austin
Director of Government Affairs

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April 23, 2012

The Honorable Max Baucus
The Honorable Orrin Hatch
United States Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD-219
Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Re: April 25 Hearing, "Tax Reform: What it Means for State and Local Tax and Fiscal Policy"

Dear Chairman Baucus, Ranking Member Hatch and Members of the Committee:

On behalf of LORD Corporation, I commend you for holding this hearing, and respectfully ask you to enact H.R. 1439, the Business Activity Tax Simplification Act ("BATSA").

LORD Corporation is a diversified technology and manufacturing company with a long history of developing breakthrough adhesive, coating and motion management technologies that significantly improve the performance of our customers' products. LORD has provided innovative solutions to demanding aerospace, defense, automotive and industrial customer problems for more than 85 years. We provide value to our customers through product design, process engineering as well as improved product performance. With world headquarters in Cary, NC, LORD has more than 2,800 employees in six U.S. states and 25 countries, and operates fifteen manufacturing facilities and six R&D centers worldwide. In 2011, LORD generated $789 million in revenues. LORD is a privately-owned company, and annually invests ten percent of revenues in new R&D.

The longstanding rule governing state taxation provides that state and local governments may impose taxes on an out-of-state company only if that company or its representative has a physical presence in the taxing state. In fact, although the U.S. Supreme Court has not ruled directly on the issue of the appropriate

nexus standard for state assessment of corporate income taxes, it has never upheld any kind of state tax on an out-of-state company unless that company had a physical presence in the taxing state.

This traditional physical presence nexus rule recognizes a practical compromise between state authority to tax and the need to protect an open, accessible and unfettered national market. Thus, the rule fosters the fundamental purposes of the Commerce Clause, preventing undue burdens on the free flow of interstate commerce and limiting the risk that the same income will be taxed multiple times.

More recently, some state and local governments have aggressively sought to increase their tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state based on the taxpayer's "economic nexus" to the taxing jurisdiction. These states have adopted a variety of ill-defined alternative nexus standards through judicial, legislative and administrative action. Economic nexus theories eliminate virtually any limit on the states' authority to impose extraterritorial taxation. Thus, such theories conflict with Supreme Court interpretations of the states' taxing authority under the Commerce Clause and subject interstate commerce to severe burdens.

Because out-of-state businesses provide an attractive target for state legislatures seeking to raise additional revenue, the economic nexus standard is spreading to other states. Political processes within the taxing state do not easily restrain the taxation of non-residents, and a state has every incentive to export its tax burden and interpret its laws aggressively to reach as many out-of-state taxpayers as possible.

The U.S. Supreme Court has refused to review several cases that challenged the constitutionality of economic nexus. Congress must help businesses, such as ours, that are suffering as a result.

The solution is enactment of BATSA. The bill, which has bipartisan support, was reported out of the House Judiciary Committee last year. BATSA would set a uniform standard for state assessment of business activity taxes. Pursuant to the bill, states would only be able to impose such taxes on companies that have employees in the state or that own or lease property there for more than fourteen days in a taxable year.

Enactment of BATSA would ensure that companies are taxed fairly and treated uniformly. It would create a clear standard that provides businesses and states with adequate understanding of when and where companies will be subject to tax. As a result, the bill would encourage investment and job creation by freeing up profits otherwise wasted by unnecessary tax litigation and preparation. Additionally, enactment of BATSA would reduce lawsuits and guesswork about

when a company's income is taxed by the states, and free companies to conduct long-term strategic planning without fear of unexpected taxation.

LORD Corporation, and all other companies that operate across state lines, not only would benefit from the provisions of BATSA, we need Congress to enact the bill to ensure greater investment in U.S. business growth and jobs. I thank you for the opportunity to present this testimony.

Sincerely,

William O. Austin
Director of Government Affairs

Frank G. Julian
Vice President
Tax Counsel

May 7, 2012

The Honorable Max Baucus
United States Senate
Washington, DC 20510

The Honorable Orrin Hatch
United States Senate
Washington, DC 20510

Re: Hearing on Tax Reform

Dear Chairman Baucus and Ranking Member Hatch:

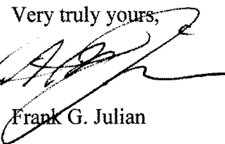
On behalf of Macy's, Inc., I would like to thank you for holding the April 25, 2012, Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy. We were particularly pleased that one of the primary issues discussed at the hearing was remote sales tax collection, as embodied in S. 1832 (the Marketplace Fairness Act).

Macy's has long supported Federal legislation that grants the states remote sales tax collection authority in a manner that provides simplification and uniformity in the tax collection process. We think it is important that Congress exercise its Commerce Clause powers to establish the parameters under which states are granted remote tax collection authority, and we think the April 25, 2012, Finance Committee hearing was an important step in achieving this goal.

Macy's, Inc., with corporate offices in Cincinnati and New York, is one of the nation's premier retailers, with fiscal 2011 sales of $26.4 billion. The company operates about 840 department stores in 45 states, the District of Columbia, Guam and Puerto Rico under the names of Macy's and Bloomingdale's, as well as the macys.com and bloomingdales.com websites. The company also operates seven Bloomingdale's Outlet stores.

Again, thank you for holding the hearing, and we look forward to working with you and your colleagues on this important matter.

Very truly yours,



Frank G. Julian

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MOTION PICTURE ASSOCIATION
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May 9, 2012

Honorable Max Baucus
Honorable Orrin Hatch
United States Senate
Committee on Finance
Attn: Editorial and Document Section
219 Dirksen Senate Office Building
Washington, D.C. 20510-6200

Re: Hearing on Tax Reform: What it means for State and Local Tax and Fiscal Policy

Dear Chairman Baucus and Ranking Member Hatch and Committee Members:

On behalf of the Motion Picture Association of America ("MPAA") [1] I thank you for the opportunity to submit this statement for the record for the April 25, 2012 hearing on Tax Reform: What it means for State and Local Tax and Fiscal Policy.

I. Introduction

From among the various Federal bills introduced in the current Congress that deal with state taxes, the MPAA has a particular interest in business activity tax nexus and thus specifically in H.R. 1439 (the Business Activity Tax Simplification Act or BATSA). H.R. 1439 was introduced in the House on April 8, 2011, and favorably reported to the full House by the House Judiciary Committee last summer. The MPAA strongly supports H.R. 1439 and respectfully urges Congress to enact the bill into law this year. The MPAA believes that a bright-line physical presence standard as provided in H.R. 1439 is the appropriate jurisdictional standard for state business activity tax purposes. In recent years, an increasing number of states have asserted that any economic presence in a state is sufficient to subject that out-of-state business to the state's direct business tax. Due to the lack of clear judicial guidance on this issue, states are taking varying, inconsistent and often aggressive positions with respect to the particular activities that may cause an out-of-state business to become subject to tax. This has created an environment of uncertainty and unpredictability for multistate businesses, especially businesses in the film, television and media-related industries when such businesses have no physical presence in the state.

This issue is of particular concern to the MPAA because of the aggressive actions taken by states in recent years against film companies, and related entities, such as broadcasters. For example, states

[1] MPAA members companies include Paramount Pictures; Sony Pictures Entertainment Inc.; The Twentieth Century Fox Film Corporation; Universal City Studios LLLP; Walt Disney Studios Motion Pictures; Warner Bros. Entertainment Inc; and associate member CBS Corporation.

have asserted business activity taxes against film and broadcasting companies claiming "economic nexus" on the following:

- Asserting that an out-of-state broadcaster should be subject to business activity tax in a state solely because the company's broadcast signals are viewed by residents in the state;
- Asserting that the digital transmission of movies to in-state customers creates nexus for an out-of-state film company for business activity tax purposes; and
- Asserting that an out-of-state film company should be subject to business activity tax if the company licenses brands, names, characters or other trademarks to unrelated third parties, who subsequently manufacture and sell merchandise bearing the licensed trademark into the state.

These examples are illustrative and only represent a few of the many state tax jurisdictional issues currently faced by the film and broadcast industry due to inappropriate state actions.

II. H.R. 1439 Provides the Appropriate Solution

Detailed below are some of the more aggressive positions taken by states that are aimed at taxing out-of-state film companies and broadcasters and the arguments advanced by states to support these positions. The MPAA believes that a physical presence nexus standard is the more appropriate jurisdictional standard for state business activity tax purposes. The provisions to modernize Public Law 86-272 contained in H.R. 1439, including the physical presence nexus standard provisions, are both fair and necessary because they are consistent with notions of where income is earned, ensure that businesses are only paying tax to those states that have provided the businesses with meaningful benefits, and represent the application of existing federal law to modern day business transactions.

Broadcast Programming. Some states have asserted that out-of-state national broadcasters should be subject to business activity taxes solely because these companies' broadcast signals are received by in-state viewers or listeners. States have tried to justify the taxation of these out-of-state broadcasters on the basis that the out-of-state broadcasters are exploiting the in-state market because the programming is seen and/or heard by individuals in the state. However, this rationale fails to recognize the basic business model employed by most national broadcasters. Specifically, broadcasters do not generate revenue from viewers or listeners. Rather, broadcasters receive revenue from advertisers that purchase air time and, in the case of cable programmers, from cable operators that carry the programming. The advertisers and cable operators are essentially the "customers" of the out-of-state broadcaster, not the in-state viewers or listeners who are the customers or potential customers of the advertisers and the cable operators. Thus, broadcasters are not "exploiting" the local market when programming is aired for individual viewers or listeners in a state. Further, broadcasters should only pay tax where they earn income, and, as discussed in more detail below, income is only earned where a business is physically located.

Remarkably, the states' position is inconsistent with the U.S. federal income tax treatment of foreign broadcasters. In fact, the issue of whether the United States may impose federal income tax on a foreign broadcaster that has no physical presence in this country has been litigated, and federal courts

have held that the United States cannot impose such a tax. [2] This holding is reinforced by the "permanent establishment" standard that the United States, along with most other countries, has adopted in its bilateral tax treaties. The permanent establishment standard requires taxpayers to have a fixed place of business (i.e., a physical presence) through which the business of the enterprise is wholly or partly carried on in order for a foreign country to impose an income tax on the business's profits. If states continue to assert positions that contradict these well-established longstanding federal tax principles, it could be potentially disastrous for America's interstate and international economy. On the other hand, the physical presence standard in H.R. 1439 is consistent with the standard used for the U.S. federal income tax treatment of foreign broadcasters, and would only tax out-of-state broadcasters that have a physical presence in the state.

Use of Trademarks in State by Unrelated Third Parties. Several states have attempted to assert taxing jurisdiction over out-of-state film companies that license brands, names, characters or other trademarks to unrelated third parties who then manufacture and sell merchandise for their own account bearing the licensed trademarks, for instance, within the state. A recent survey of state tax departments revealed that more than 30 states take the position that the licensing of trademarks to either an affiliated or unrelated entities with a location in the state would create nexus for the licensor for corporation income tax purposes. [3] These states are overreaching and attempting to tax income that is earned outside of the states' borders.

Film companies do not earn their income in the states where merchandise bearing their trademarks is sold by third parties; rather, they earn their income where they actually engage in business activities (i.e., where they have property and employees). The physical presence nexus standard contained in H.R. 1439 would ensure that income is only taxed in those states where the income is earned.

Digital Transmission of Movies. Some states have asserted that out-of-state film companies should be subject to business activity tax if the out-of-state company sells digital films to in-state customers who download the films over the Internet. States assert that they are entitled to tax these out-of-state sellers because the state has provided an in-state market for digital product. However, state governments maintain a "viable marketplace" for the benefit of their constituents, the in-state customers, and not for the benefit of out-of-state sellers. Further, the imposition of a business activity tax on an out-of-state seller simply cannot be justified on the basis that the government has provided some nebulous and incidental benefit. Rather, the benefits and protections provided by a taxing jurisdiction must be meaningful to warrant the imposition of a business activity tax. Businesses only receive these meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers) in the jurisdictions where they are actually located due to the presence of a labor force or property. Further, as previously discussed, businesses should also only pay tax to those states where income is earned, and income is simply not earned where a business's customers are located. Thus, businesses should only pay tax to those jurisdictions where they are physically present. H.R. 1439 would promote

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[2] *See Commissioner of Internal Revenue v. Piedras Negras B. Co.*, 127 F. 2d 260 (5th Cir. 1942).

[3] *Special Report: 2008 Survey of State Tax Departments*, 15 Multistate Tax Rep't 4 at S-28 (April 25, 2008).

fairness by ensuring that businesses are only taxed by those jurisdictions that have provided meaningful benefits and protections and in those jurisdictions where income was earned.

In the context of digital downloads, we should also point out some of the peculiar results that can arise if Public Law 86-272 is not modernized for today's economy and modern technologies. For example, if an out-of-state film company conducts in-state solicitation activities aimed to promote the sale of DVDs (i.e., tangible personal property), the orders for which are accepted and shipped or delivered from outside the state, this in-state solicitation would be protected under current law by Public Law 86-272. On the other hand, if an out-of-state film company were to conduct the same in-state solicitation activities to promote digital downloads (i.e., intangible property) for the very same film, these solicitation activities would not be protected by Public Law 86-272. This example clearly demonstrates why the provisions of Public Law 86-272 must be modernized, as provided in H.R. 1439, to protect the solicitation of orders for services and intangible property. As our economy continues to shift towards intangibles and services, it is important that these sectors of the economy be afforded the important protections of Public Law 86-272.

Finally, unlike prior versions of H.R. 1439, the bill now includes a provision intended to prevent states from circumventing the intent of the legislation. Under that provision, states that require or permit a group of related or affiliated corporations to use a combined reporting tax return methodology to compute the tax liability of corporations within the combined group that are subject to a state's taxing jurisdiction under the tax nexus standards of H.R. 1439 may not indirectly impose tax on the group members that are not themselves subject to tax in that state under such tax nexus standards. Thus, H.R. 1439 prohibits a state from taxing a corporation that is not otherwise subject to tax in the state by using the end-around run frequently referred to as the Finnigan method of combined reporting. The MPAA supports this critical element of H.R. 1439.

III. Conclusion

The MPAA believes that it is necessary for Congress to provide clear guidance to the states in the area of state tax jurisdiction and put a stop to the aggressive actions being taken by the states. In the absence of Congressional action, these state actions will likely have a chilling effect on interstate commerce. H.R. 1439 would provide a much needed bright-line physical presence standard that is both fair and reasonable, and would modernize Public Law 86-272 to account for the current state of our economy. As states continue to attempt to maximize revenues, they will likely become even more aggressive in their attempts to tax out-of-state businesses making the need for Congressional action all the more urgent. Therefore, the MPAA strongly urges your Committee to include the provisions of H.R. 1439 in any package of legislation affecting state taxes that your Committee considers and approves.

Sincerely,

Michael P. O'Leary
Senior Executive Vice President Global Policy & External Affairs
Motion Picture Association of America, Inc.

Statement on the Topic of

Tax Reform: What it means for State and Local Government Tax and Fiscal Policy

Committee on Finance
United States Senate

Hearing of April 25, 2012

For additional information, contact:
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Introduction

The Multistate Tax Commission presents its views for inclusion in the hearing record with respect to the Committee on Finance's hearing on *Tax Reform: What it means for State and Local Government Tax and Fiscal Policy*, held on April 25, 2012.

The Commission is an intergovernmental state tax agency created in 1967 by interstate compact as an effort to protect state tax authority and a means to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Forty-seven states and the District of Columbia participate in the Commission, and twenty of these jurisdictions have enacted the Multistate Tax Compact into their statutes. The Commission's focus on the preservation of state sovereignty usually means the Commission writes in opposition to federal legislation that encroaches on states' tax authority as established in our system of federalism. But we always seek to help Congress maintain the careful balance implicated by states' sovereignty and Congress's constitutional and federal responsibilities in a way that benefits taxpayers and government at all levels.

Historically, there has been no more contentious issue among states and taxpayers than the issue of nexus: When does a taxpayer that is doing business in a state become subject to that state's tax laws? The proponents of a physical presence nexus standard for state income taxation attract people to their cause with talk of minor activities in states resulting in onerous corporate tax liabilities, but then actually promote a measure, H.R. 1439, *the Business Activity Tax Simplification Act of 2011* (BATSA) that allows large, multistate businesses with millions of dollars of sales in a state to avoid paying the corporate taxes that are being paid by small, in-state businesses. A congressionally-imposed business activity tax nexus threshold as set forth in H.R. 1439 would foster inequity between big and small businesses, and thus create an unbalanced market environment where giant multistate and multinational corporations could compete, without paying taxes, with local businesses. And it is predicated on the myth that "the historical [nexus] standard is that states may tax those physically present in the jurisdiction."[1] As applied to the income tax, such a standard is not supported by applicable Supreme Court jurisprudence and is unsound as a matter of tax policy.

Businesses Can Conduct Extensive Activity in a State without a Physical Presence

A business entity does not have a "physical presence" of its own. A business entity—be it a corporation, a partnership, an LLC or other pass-through entity—is a legal instrument, created entirely by state law. As such, a business has no "physical presence" anywhere, even at its principal place of business. The Supreme Court explained that "the terms 'present' or 'presence' [when used with reference to a corporation] are used merely to symbolize those activities of the [corporation] within the state." *Int'l Shoe Co. v. Washington*, 326 US 310, 316

[1] Joseph Henchman, "The Proper Role of Congress in State taxation: Preventing Harm to the National Economy," Presented at the Hearing on "Tax Reform: What it Means for State and Local Fiscal Policy," Before the Committee on Finance, U.S. Senate, April 25, 2012, p. 5.

(1945). Those activities can be symbolized through people that the business employs (either employees, contractors or other representatives), property that the business owns or leases, or other any other physical form by which the business carries out an activity. But a business, particularly in the Internet Age, can engage in the same market activities remotely, with little or no physical symbol in the market state. In the modern economy, predicating income tax nexus on a symbolic "physical presence" is not a helpful concept. Instead, grounding nexus on whether a business is purposefully engaged in market-enhancing activities in the taxing state, with or without a symbolic physical manifestation of those activities, accurately reflects both the purpose and nature of the activities in which the modern business routinely engages.

The U.S. Supreme Court Has Not Required a Physical Presence Standard for State Income Taxation

Under its Due Process Clause jurisprudence, the Supreme Court recognized that a state may tax a business on the value of, or income earned from, intangibles with a business situs in a state, even if the business does not have a physical presence in that state.[2] The Court has said that, in regards to state taxation of intangibles or the income derived from intangibles, the presence of real or tangible personal property in the state is of no constitutional significance:

> Nor are we able to perceive any sound reason for holding that the owner must have real estate or tangible property within the state in order to subject its intangible property within the state to taxation.

Virginia v. Imperial Coal Sales Co., 293 U.S. 15, 20 (1934), quoted in *Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 213 (1936).

While the Supreme Court has not directly addressed the issue of what is the applicable Commerce Clause income tax nexus standard, it twice noted in the *Quill* case that it has never imposed a physical presence requirement for any tax other than for use tax collection. *Quill Corporation v. North Dakota*, 504 U.S. 298 at 314, 317 (1992). Indeed, Congress enacted P. L. 86-272 in 1959 precisely out of concerns that the Court was likely to find solicitation activities alone are sufficient to create nexus. But Congress did not enact a general statute requiring all businesses to have physical presence before a state could impose its income tax. Rather, Congress created a limited—and temporary—safe harbor from nexus for sellers of tangible personal property whose only activity in the taxing state is solicitation of orders.

[2] Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936) (finding West Virginia ad valorem property tax on accounts receivable and bank deposits of Delaware corporation did not violate Due Process Clause as West Virginia was the business situs of the intangibles); New York ex rel. Whitney v. Graves, 299 U.S. 366 (1937) (upholding the New York tax on income derived from sale by non-resident of membership in New York Stock Exchange as New York was the business situs of the license); First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937) (Delaware corporation properly subject to Minnesota ad valorem property tax on value of stock in banks chartered in Montana and North Dakota as Minnesota was the business situs of the stock); Int'l Harvester Co. v. Wisc. Dep't of Taxation, 322 U.S. 435 (1944) (Wisconsin Privilege Dividend Tax properly applied to dividends received by non-resident shareholder declared and paid outside of state by foreign corporation doing business in Wisconsin).

Activities by sellers of tangible personal property that are unrelated to solicitation are not protected. Nor are businesses that provide services or deal in intangibles.

Thus, the historical record is clear. The Supreme Court has long held that a business need not have physical presence to be subject to state income tax and Congress, with limited exceptions, has not seen fit to disturb that rule.

States Have Adopted an Economic Presence Standard, Rather than a Physical Presence Standard, for Income Taxation

The proponents of BATSA also assert that without a federally imposed physical presence standard, states will adopt divergent nexus standards throughout the country, with resultant taxpayer confusion and undue administrative burdens for business. In fact, the overwhelming trend in state taxation—legislatively, administratively, and judicially—is towards adoption of an economic presence nexus standard for income tax. Courts have been virtually unanimous in finding that a physical presence is not required for states to impose corporate income tax.[3] Supported by this well-established legal authority, states have concluded that in today's modern economy, a physical presence is no longer a credible indicator of the degree of economic activity in a state, and only three states require it.[4] H.R. 1439 would reverse the rule of law in all but those three states.

The Commission agrees that a uniform nexus threshold would reduce compliance burdens, for the states as well as taxpayers. That uniform nexus threshold should be adopted by the states, however, and should apply to economic presence, not physical presence. The Commission advocates the state adoption of a factor presence nexus threshold. The factor presence standard simply takes into consideration a corporation's property, payroll, and sales in a state to determine if a business has a tax obligation there. Moreover, it uses de minimis

[3] KFC v. Iowa Dep't. of Revenue, 792 N.W. 2d 308 (Iowa 2010), *cert. denied*, 132 S. Ct. 97 (2011) ; Geoffrey, Inc. v. Comm'r of Revenue, 899 N.E. 2d 87 (2009.), *cert. denied*, 129 S.Ct. 2853 (2009); Lanco, Inc. v. Dir., Div. of Taxation, 879 A.2d 1234 (App. Div. 2005), *aff'd* 188 N.J. 380 (2006), *cert. denied*, 127 S. Ct. 2974 (2007) ; Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13 (1993), *cert. denied*, 114 S. Ct. 550 (1993); A&F Trademark, Inc. v. Tolson, 605 S.E. 2d 187 (2004), *cert. denied*, 126 S.Ct. 353 (2005); Tax Comm'r of State v. MBNA Am. Bank, N.*A.* 640 S.E. 2d 226 (2006), *cert. denied*, 127 S. Ct. 2997 (2007); FIA Card Services, N.A. v. Tax Comm'r of W. Virginia, 127 S. Ct. 2997 (2007); Capital One Bank & Capital One F.S.B. v. Comm'r of Revenue, 899 N.E.2d 76 (2009), *cert. denied*, 129 S. Ct. 2827 (2009); Comptroller of the Treasury v. SYL, Inc., 825 A. 2d 399 (2003), *cert. denied* 124 S. Ct. 478 (2003); Sec'y, Dep't. of Revenue, State of La. v. GAP (Apparel), Inc., 886 So. 2d 459 (LA Ct. App. 2004); Bridges v. Geoffrey, Inc., 984 So. 2d 115 (LA Ct. App. 2008), *writ denied sub nom.* 978 So. 2d 370; Geoffrey, Inc. v. Oklahoma Tax Comm'n, 132 P. 3d 632 (2005). *But see* In the Matter of the Income Tax Protest of Scioto Insurance Co., Supreme Court of Oklahoma Case Number 108943 (May 1, 2012) (no due process nexus with second-tier intellectual property holding company whose only contact with state was receipt of royalty payments from an Oklahoma taxpayer – the first-tier royalty recipient – under a contract not made in Oklahoma) *and* J.C. Penney Nat'l Bank v. Johnson, 19 S.W. 3d 831 (Tenn. Ct. App. 1999) (court applies physical presence nexus rule without deciding whether Commerce Clause compelled such a standard).

[4] CCH ¶ 10-075 (May, 2012)

thresholds that would protect small businesses operating below a defined level. Nine states have adopted these types of de minimis thresholds in the last four years.[5] A factor presence standard provides the certainty that H.R. 1439 is supposedly striving for in a way that is consistent with modern business practices and that does not overturn well-established legal precedent, harm state revenues, or violate principles of federalism. A copy of the Commission's Factor Presence Nexus Standard is attached as an Exhibit.

The Tax Foundation claims that basing nexus standards on a concept of physical presence represents good tax policy:

> 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 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 or live there. A physical presence standard for state taxation would be in line with this fundamental view of taxation.[6]

In this statement, Tax Foundation equates benefits received from public expenditures to physical presence. This argument is as fallacious today as it was in the days of sailing ships and caravans. The major benefits received by those engaging in inter-jurisdictional commerce are the protections offered by the courts and public safety personnel. Courts offer a peaceful and legal means of resolving disputes between the parties in commercial transactions and public safety personnel protect the lives of those transporting goods across boundaries as well as protecting the property being transported. It is also widely recognized that state and local government expenditures for health and education provide benefits that transcend their boundaries. State and local government expenditures for these services result in a more productive workforce which benefits the entire society, not just those who are the direct recipients of those expenditures.

The benefit principle does not necessarily apply to state corporate income taxes. Public finance expert Peggy Musgrave classified the corporate income tax as an entitlement tax in that the jurisdictions in which the income is earned are entitled to tax a share of the corporate profits.[7]

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[5] *Id.*

[6] Henchman, op.cit, p. 5.

[7] Peggy B. Musgrave, "Principles in Dividing the State Corporate Tax Base." In The State Corporation Income Tax: Issues in Worldwide Unitary Combination, edited by Charles McLure, Jr. 228-45. Stanford, VA: Hoover Institution Press, 1984

Another noted public finance expert, Charles McLure,[8] explains that neither the federal nor the state corporate income tax reflects the benefits to, or the costs of, the public services provided to corporations:

- Benefits are provided to non-corporate entities
- Benefits are provided to unprofitable entities
- Benefits are not related to profitability.

Furthermore, of all of Adam Smith's canons of taxation, the benefit principle of taxation is not the only or even the most important principle. In the estimation of many economists, other principles usually rank higher than the benefit principle. These are: neutrality, ability to pay, and administrative costs to tax authorities and taxpayers. Therefore, when all principles of taxation are considered, it would be a rarity that the benefits received from public expenditures, assuming they could be accurately measured, would approximate the taxes paid.

"Nexus Uncertainty" not the Ominous Specter it's Made Out to be

Proponents of a physical presence nexus standard raise the specter of "nexus uncertainty" because there are more than 9,600 jurisdictions with sales taxes.[9] Citing the large number of jurisdictions imposing sales taxes is meant to give the impression that no business can possibly comply with the myriad definitions, rules, tax rates, tax bases, boundaries and boundary changes, etc. The focus of these comments on recent developments in the state sales tax appears to be a critique of the Streamlined Sales Tax Project (SSTP). But, regardless of the current state of the SSTP, *Quill*'s establishment of a physical presence nexus standard for use tax collection remains the law of the land. It is therefore difficult to understand the relevance of these arguments. They appear to be arguing that there is a danger that Congress would enact the Main Street Fairness Act even if the SSTP failed to achieve its goal of simplifying use tax collection for remote sellers. Given that simplification is precisely the quid pro quo for the Main Street Fairness Act to take effect, it is highly unlikely that Congress would enact the statute in the absence of such simplification. Whatever relevance the number of state and local sales tax jurisdictions in the United States prior to 1992, *Quill* addressed those concerns.

In addition, the fact that there are a large number of local jurisdictions that currently impose, or have the option to impose sales taxes does not necessarily mean undue complexity. First, only a small number of business firms, if any, are subject to the laws of all 9,600-plus jurisdictions, and often those firms that are large enough to operate just about everywhere often earn a profit from collecting and remitting sales taxes. In addition, there are 12 states that have neither locally imposed sales taxes nor local option sales taxes (Connecticut, District of Columbia, Hawaii, Indiana, Kentucky, Maine, Massachusetts, Michigan, Mississippi, New

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[8] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," National Tax Journal, LIII, No. 4, Part 3, December 2000, pp. 1288-1289.

[9] Henchman, op.cit, p. 8

Jersey, Rhode Island, and West Virginia). Moreover, in only 6 states (Alabama, Alaska, Arizona, Colorado, Idaho, and Louisiana) do local tax bases differ from the state tax base and from each other; and, each locality with a sales tax administers their own tax. It is in these states that complexity can become a significant burden, especially for small businesses. One of Tax Foundation's proposed solutions for the non-uniformity of state sales taxes is the discredited idea of origin-based taxation. The example provided is a multistate retailer—Amazon would collect Washington state sales taxes on all sales under the assumption that base state collection is a benefit tax because Amazon's Washington based employees benefit from Washington schools, roads, police and fire protection, etc. It is difficult to believe that there would be widespread public support for the idea that residents of states other than Washington should pay Washington sales taxes because the Washington base employees of Amazon enjoy the benefits of Washington public services.

BATSA, the Largest Unfunded Mandate Yet

Proponents of a physical presence nexus standard are urging Congress to pass uniform nexus laws on the states which, in the case of business activity taxes, imposes one of the largest unfunded mandates since the Congressional Budget Office has been tasked with measuring these costs. CBO estimates that the costs—in the form of forgone revenues—to state and local governments would be about $2 billion in the first full year after enactment and at least that amount in subsequent years.[10] An earlier study by the National Governors' Association concluded that imposing physical presence nexus standards for all business activity taxes would result in revenue losses of approximately $6.6 billion in fiscal year 2007; and rising thereafter.[11] On the other hand, claims regarding the economic benefits of this proposed Congressional action remain unsubstantiated.

A Physical Presence Standard is an "Anti-Jobs" Standard

A physical presence standard would create a disincentive for business to locate jobs or investment in the states. This is because, under the bill, businesses could avoid paying state taxes if they avoid creating physical presence—such as employees, an office, or a production or distribution facility—in a state. Passage of H.R. 1436 would amount to telling multistate and multinational businesses that they may continue to profit from your state's consumer market in competition with local businesses, but no longer have to pay your state taxes, as long as they make sure they do ***not*** create jobs or locate facilities in your state. Proponents of a physical presence standard say it would "encourage business growth and job creation" —maybe, but not in the United States.

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[10] Congressional Budget Office Cost Estimate of H.R. 1439, Business Activity Tax Simplification Act of 2011, September 13, 2011.

[11] National Governors Association, "Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States," State Tax Notes, Tax Analysts, Inc. Falls Church, Virginia, November 7, 2005, p.560.

Conclusion

In today's economic environment, an act which discourages job creation in the states, and so clearly benefits large multistate corporations over our struggling small local businesses, should not be considered. There is no need for federal preemption of this critical state issue. Therefore, we are asking Congress to refrain from passing legislation that would unduly interfere with the states' ability to raise sufficient revenue to finance their necessary public services.

Thank you for the opportunity to present our views on the important implications of tax reform for state and local government tax and fiscal policy.

Factor Presence Nexus Standard for Business Activity Taxes

Approved by the Multistate Tax Commission
October 17, 2002

The Commisison adopted the following uniformity proposal as part of an amendment to MTC Policy Statement 02-02, *Ensuring the Equity, Integrity and Viability of State Income Tax Systems*, approved on October 17, 2002. A working group of states formulated the proposal over several months through public teleconferences and the Commission held four public hearings covering the technical, policy and constitutional aspects of the proposed provision. This factor presence nexus standard is intended to represent a simple, certain and equitable standard for the collection of state business activity taxes. Professor Charles McLure, Senior Fellow with the Hoover Institution at Stanford University, originated the idea of factor presence nexus and set forth an explanation of the concept in his December 2000 *National Tax Journal* article entitled, "Implementing State Corporate Income Taxes in the Digital Age." Professor McLure reiterated his concept during the Commission's July 2001 *Federalism at Risk* seminar.

A. (1) Individuals who are residents or domiciliaries of this State and business entities that are organized or commercially domiciled in this State have substantial nexus with this State.

(2) Nonresident individuals and business entities organized outside the State that are doing business in this State have substantial nexus and are subject to [list appropriate business activity taxes for the state, with statutory citations] when in any tax period the property, payroll or sales of the individual or business in the State, as they are defined below in Subsection C, exceeds the thresholds set forth in Subsection B.

B. (1) Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.

(2) At the end of each year, the [tax administrator] shall review the cumulative percentage change in the consumer price index. The [tax administrator] shall adjust the thresholds set forth in paragraph (1) if the consumer price index has changed by

5% or more since January 1, 2003, or since the date that the thresholds were last adjusted under this subsection. The thresholds shall be adjusted to reflect that cumulative percentage change in the consumer price index. The adjusted thresholds shall be rounded to the nearest $1,000. As used in this subsection, "consumer price index" means the Consumer Price Index for All Urban Consumers (CPI-U) available from the Bureau of Labor Statistics of the United States Department of Labor. Any adjustment shall apply to tax periods that begin after the adjustment is made.

C. Property, payroll and sales are defined as follows:

(1) Property counting toward the threshold is the average value of the taxpayer's real property and tangible personal property owned or rented and used in this State during the tax period. Property owned by the taxpayer is valued at its original cost basis. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period; but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

(2) Payroll counting toward the threshold is the total amount paid by the taxpayer for compensation in this State during the tax period. Compensation means wages, salaries, commissions and any other form of remuneration paid to employees and defined as gross income under Internal Revenue Code § 61. Compensation is paid in this State if (a) the individual's service is performed entirely within the State; (b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or (c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State.

(3) Sales counting toward the threshold include the total dollar value of the taxpayer's gross receipts, including receipts from entities that are part of a commonly owned enterprise as defined in D(2) of which the taxpayer is a member, from

(a) the sale, lease or license of real property located in this State;

(b) the lease or license of tangible personal property located in this State;

(c) the sale of tangible personal property received in this State as indicated by receipt at a business location of the seller in this State or by instructions, known to the seller, for delivery or shipment to a purchaser (or to another at the direction of the purchaser) in this State; and

(d) The sale, lease or license of services, intangibles, and digital products for primary use by a purchaser known to the seller to be in this State. If the seller knows that a service, intangible, or digital product will be used in multiple States because of separate charges levied for, or measured by, the use at · different locations, because of other contractual provisions measuring use, or because of other information provided to the seller, the seller shall apportion the receipts according to usage in each State.

(e) If the seller does not know where a service, intangible, or digital product will be used or where a tangible will be received, the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is available from the business records of the seller maintained in the ordinary course of business when such use does not constitute bad faith. If that is not known, then the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is obtained during the consummation of the sale, including the address of the purchaser's payment instrument, if no other address is available, when the use of this address does not constitute bad faith.

(4) Notwithstanding the other provisions of this Subsection C, for a taxpayer subject to the special apportionment methods under [Multistate Tax Commission Regulations IV.18.(d) through (j)], the property, payroll and sales for measuring against the nexus thresholds shall be defined as they are for apportionment purposes under those regulations. Financial institutions subject to an apportioned income or franchise tax shall determine property, payroll and sales for nexus threshold purposes the same as for apportionment purposes under the [MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions]. Pass-through entities, including, but not limited to, partnerships, limited liability companies, S corporations, and trusts, shall determine threshold amounts at the entity level. If property, payroll or sales of an entity in this State exceeds the nexus threshold, members, partners, owners, shareholders or beneficiaries of that pass-through entity are subject to tax on the portion of income earned in this State and passed through to them.

D. (1) Entities that are part of a commonly owned enterprise shall determine whether they meet the threshold for nexus as follows:

(a) Commonly owned enterprises shall first aggregate the property, payroll and sales of their entities that have a minimum presence in this State of $5000 of combined property, payroll and sales, including those entities that independently exceed a threshold and separately have nexus. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. If that aggregation of property, payroll and sales meets any threshold in Subsection B,

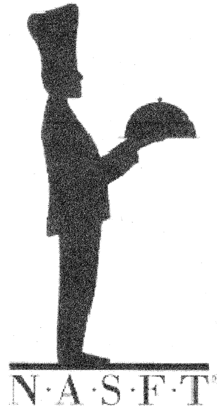
the enterprise shall file a joint information return as specified by the [tax agency] separately listing the property, payroll and sales in this State of each entity.

(b) Those entities of the commonly owned enterprise that are listed in the joint information return and that are also part of a unitary business grouping conducting business in this State shall then aggregate the property, payroll and sales of each such unitary business grouping on the joint information return. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. The entities shall base the unitary business groupings on the unitary combined report filed in this State. If no unitary combined report is required in this State, then the taxpayer shall use the unitary business groupings the taxpayer most commonly reports in States that require combined returns.

(c) If the aggregate property, payroll or sales in this State of the entities of any unitary business of the enterprise meets a threshold in Subsection B, then each entity that is part of that unitary business is deemed to have nexus and shall file and pay income or franchise tax as required by law.

(2) "Commonly owned enterprise" means a group of entities under common control either through a common parent that owns, or constructively owns, more than 50 percent of the voting power of the outstanding stock or ownership interests or through five or fewer individuals (individuals, estates or trusts) that own, or constructively own, more than 50 percent of the voting power of the outstanding stock or ownership interests taking into account the ownership interest of each such person only to the extent such ownership is identical with respect to each such entity.

E. A State without jurisdiction to impose tax on or measured by net income on a particular taxpayer because that taxpayer comes within the protection of Public Law 86-272 (15 U.S.C. § 381) does not gain jurisdiction to impose such a tax even if the taxpayer's property, payroll or sales in the State exceeds a threshold in Subsection B. Public Law 86-272 preempts the state's authority to tax and will therefore cause sales of each protected taxpayer to customers in the State to be thrown back to those sending States that require throwback. If Congress repeals the application of Public Law 86-272 to this State, an out-of-state business shall not have substantial nexus in this State unless its property, payroll or sales exceeds a threshold in this provision.



TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

STATEMENT FOR THE RECORD
OF THE

NATIONAL ASSOCIATION
FOR
THE SPECIALTY FOOD TRADE, INC.

to the
UNITED STATES SENATE COMMITTEE ON FINANCE

April 25, 2012

The National Association for the Specialty Food Trade, Inc. (NASFT) welcomes this opportunity to present to the Senate Committee on Finance its views about the collection of business activity taxes by several states in contravention of the intent of the interstate commerce clause. Any tax

reform should clarify that an out of state seller must have a physical presence (nexus) in the state before a business activity tax may be imposed.

Congress can, and should, clarify a uniform meaning of nexus based on physical presence. The failure of the United States Supreme Court to do so has created uncertainty for businesses and multiple state interpretations of the nexus requirement. The varying state interpretations and enforcement of nexus are a significant hindrance to the ability and willingness of small businesses to sell in interstate commerce. The economic nexus tests used by some states are so costly that many successful small food companies forego their right to conduct interstate commerce in some states in order to avoid the possibility of unfair tax assessments.

Several NASFT members - small businesses - have paid thousands of dollars in assessments and back taxes rather than fight claims for the payment of state business activity taxes, although they had no presence in the taxing jurisdiction and acted only through brokers or other independent contractors.

Most small food companies cannot afford a physical presence in states other than their home jurisdiction. When the business grows so that it is reasonable to sell outside the home territory, a small food company often reaches into the interstate market through the mail or through a broker in the other state. The broker is an independent contractor - another independent small business – which sells the product lines of several companies and earns commissions. If the food manufacturer is successful, it pays income taxes to its own state authorities – in return for the safety, educational and other services that it receives. And the broker pays taxes on its commissions to its state authorities – again in return for local services. Each taxing jurisdiction receives revenue from those with nexus to the jurisdiction, in keeping with a constitutional scheme that protects interstate commerce and the businesses that sell in the national marketplace. Both pay federal and other taxes, as required. The aggressive state collection of business activity taxes from out of state sellers upsets the constitutional scheme.

The National Association for the Specialty Food Trade, Inc., based in New York City, is the trade association for all segments of the specialty food industry. Specialty foods are high-value, high-quality, innovative processed foods, such as chocolates, cheeses, snack foods, specialty meats, honey, cider and other beverages. NASFT has a national membership of approximately 2,900 companies located throughout the United States and has affiliate members overseas. The membership includes manufacturers and

processors, brokers, distributors and retailers. Most NASFT members are small businesses (well below $1 million in annual sales). Out of state sales are a means to grow the businesses. As small businesses with limited financial resources, few staff and usually no full-time professional advisers (e.g., legal and accounting), they are particularly affected by unexpected and unfair taxes imposed outside their home jurisdiction.

In conclusion, the Senate Committee on Finance and the Congress, in reforming the federal tax laws, should clarify that an out of state seller must have a physical presence (nexus) in a state before a business activity tax may be imposed.

Thank you for this opportunity to present the views of the small businesses that are members of the NASFT.

ICMA NATIONAL LEAGUE of CITIES

April 23, 2012

The Honorable Max Baucus	The Honorable Orrin Hatch
Chairman, Committee on Finance	Ranking Member, Committee on Finance
United States Senate	United States Senate
219 Dirksen Senate Office Building	219 Dirksen Senate Office Building
Washington, D.C. 20510	Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch:

On behalf of the organizations listed above representing our nation's cities, towns and counties, we appreciate the opportunity to submit the following comments to the Senate Finance Committee as you discuss what federal tax reform could mean for state and local fiscal and tax policy. Our comments today highlight three specific areas: (1) maintaining the federal tax exemption on municipal bonds to promote job creation and improving the nation's infrastructure; (2) ensuring that state and local governments retain the authority to set their own tax policy; and (3) opposing federal preemptions that would grant preferential tax treatment to certain industries and threaten the fiscal health of state and local governments.

Our organizations share a long-standing opposition to any preemption by Congress of local taxing authority. How to levy taxes fairly, how to ensure there is no discrimination among companies that provide different forms of the same service, and how to protect local government revenues are all matters that should be resolved at the state and local level.

Local governments exercise their taxing authority to the extent provided by state law. As a result, local taxing authority and practices differ from state to state, and from county to county and city to city within a state. This means that every local government tailors its tax policy by taking into account the sources of revenue available and the needs and desires of its residents. More importantly, local officials making these decisions are accountable to the voters and taxpayers in their communities for the expenditure of funds on public services. Our citizens already have the power to change locally imposed taxes and do not need to be subjected to a one-size-fits all federal tax policy.

In today's difficult economic times, when local governments are facing the fifth straight year of declines in revenue with further declines projected for 2012, local taxing autonomy is crucial in helping to ensure that the needs of local citizens are met. The ability to make tax and other fiscal policy decisions at the local level, without federal interference, enables local officials to provide the quality services our shared citizens expect. In considering any changes to the federal tax code, we simply ask that you respect local authority and that you act to promote the intergovernmental partnership by authorizing the collection of local taxes already owed on Internet and mail-order sales. Accordingly, we call on Congress to immediately pass the *Market Place Fairness Act* (S. 1832).

We also think it is important to maintain the long-standing partnership between the federal government, and states and local governments through the federal tax exemption of interest earned on municipal bonds. Tax-exempt bonds help finance the construction and maintenance of three-quarters of the public infrastructure throughout the United States. This long-standing federal tax policy allows local governments to save approximately two-percentage points on their borrowing costs to finance the vast majority of all public infrastructures in our nation, which translates into savings to local taxpayers.

The following is a more detailed discussion of our policies related to these issues.

Maintaining the Federal Exemption on Municipal Bonds

State and local governments access the tax-exempt bond market to provide essential infrastructure and services to their citizens. Without access to this type of financing, the cost to taxpayers for providing schools, libraries, public buildings and hospitals, roads and bridges and sewers and waterways would be much greater. Tax-exempt bonds are not just a useful means to provide this important public service; they also are a well-established product for investors. More than 75% of municipal bonds are owned by individuals, from an array of income brackets.

Tax- exempt financing has a solid investor base and established legal infrastructure that allows a variety of communities, both small and large, to effectively serve the needs of diverse constituencies. There are over $2.9 trillion in outstanding tax-exempt bonds, issued by 50,000 separate government units.

The federal tax exemption of municipal bond interest is long standing. It is neither a loophole nor a special interest tagalong provision. In fact, Congress has exempted municipal bond interest since the income tax code was promulgated in 1913 and has continued to do so for 99 years.

The role tax-exempt bonds play is a great example of the federal, state and local partnership. State and local governments are responsible for building and maintaining 75% of our country's infrastructure, with a majority of these projects financed through tax-exempt bonds. The yield an investor receives for tax-exempt bond purchases is usually 200 basis points lower than what they would receive on taxable bond purchases. However, because of the tax benefit, municipal bonds become a comparable investment, and one known to be among the safest in the world. This allows governments to borrow at a lower rate, saving billions of taxpayer dollars. The cost to the federal government of not taxing these investments is insignificant compared to the overall benefit that tax-exempt bonds provide for each community. In fact, tax-exempt bonds are the best way to integrate the needs of each community effectively, as the decision to issue bonds for various projects is determined and approved by either the citizens themselves or their elected legislative bodies.

The only logical way for the federal government to be a partner in infrastructure funding is by supporting the tax-exemption of municipal securities.

Congress and national leaders often discuss the need for shoring up our country's infrastructure. The American Society of Civil Engineers reports that it will cost state and local governments $2.2 trillion over the next five years to meet physical infrastructure needs. At this time, when infrastructure demands are great, yet direct federal assistance to state and local governments is shrinking, the ability of states and localities to issue tax-exempt bonds becomes more significant. Without these bonds, state and local

governments and taxpayers will struggle with increased borrowing costs, and financing for infrastructure construction and maintenance will stagnate. Businesses and communities that depend on infrastructure for commerce, public safety, job creation and the development of an educated workforce will suffer, no doubt jeopardizing the country's already fragile economic recovery.

Unfortunately, there are several tax proposals circulating that would dampen the effectiveness of the bond market, creating higher borrowing costs for state and local governments, less investment in infrastructure, and fewer jobs. This comes at a time when state and local governments are still struggling to recover from the Great Recession. Many local governments are facing budget shortfalls that continue to force them to make deeper cuts in critical public services and delay infrastructure investments.

One of the tax proposals circulating would cap certain tax deductions and exclusions for high income taxpayers, including tax-exempt interest on municipal securities. This cap would effectively amount to a tax on tax-exempt bonds - for both new issuances and bonds that are outstanding. Such a retroactive policy shift has never occurred before in this market, and would have the detrimental effect on investor's appetite for tax-exempt bonds. This would drive up the borrowing costs of state and local governments. Similarly, the proposal to place an additional sliding cap on the benefits of deductions and exclusions, including tax-exempt bonds, would also be detrimental to local governments. This sliding cap would change from year to year and would be especially troubling for tax-exempt bonds, since it would be virtually impossible for investors to predict the tax rate for their municipal bond interest income over the life of their investments and would create a strong disincentive to buy tax-exempt municipal bonds.

Other proposals to replace tax-exempt bonds with tax credit bonds or direct subsidy bonds also would raise costs for state and local governments and their citizens. These programs work best as a complement to -- not a replacement of -- tax-exempt bonds. Congress should carefully look at how various tax credit bond programs have worked in practice versus in theory, when reviewing their role in the marketplace.

Simply, the tax-exempt bond market is a smart, cost-effective investment for state and local governments, investors and the federal government. No amount of appropriations or other financing tools match their effectiveness for financing infrastructure needs that serve individual communities and the country at large.

Ensuring that State and Local Governments Retain the Authority to Set Their Own Tax Policy Based on the Needs of Their Constituents

Federal Deduction of State and Local Taxes

We oppose the elimination or reduction, phased or otherwise, of state and local tax deductions. The deductibility of personal state and local income, property and sales taxes on federal tax returns recognizes the historic relationship of the federal, state, and local governments and the fact that all levels of government provide vital services. The elimination or reduction of state and local tax deductions would only increase state and local taxes for citizens.

Since the federal income tax was adopted in the early 20th century, there has been recognition that independent state and local government tax structures should be respected. State and local tax deductibility has contributed to the stability of tax revenues that are reliable and flexible. As state and local governments must balance their budgets, any change that disrupts the stability of their tax structure could only harm their ability to provide essential services, especially during recessions. The deductibility of state and local taxes supports their efforts to set tax rates at levels that efficiently match the service demands of their residents across a range of incomes and needs. Deductibility of these taxes also minimizes unhealthy market swings during times of economic change.

One key example of the importance of state-local tax deductibility is housing. Housing is a highly valued asset for residents and communities. Should deductibility of property taxes be eliminated or reduced, more volatility would be introduced into the housing sector, and could well reduce property tax revenues if such a change further curbed housing sales and prices. Historically, the deductibility of the property tax has often been a positive element in stabilizing housing values and markets. The recent economic downturn and the related housing crises are important reminders that property tax deductibility can support a housing recovery and, in time, restore government property tax revenues.

Encourage State and Local Sales Tax Collection

As the increasing strength of electronic commerce creates exciting new marketplaces, it has also put traditional retail outlets at an unfair disadvantage because of outdated and inequitable tax and regulatory environments. The Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) left state and local governments unable to adequately enforce their existing sales tax laws on sales by out-of-state catalog and online sellers. But Congress, with its clear constitutional authority to regulate interstate commerce, can give states and local governments the option to require sellers who do not have a physical presence in their jurisdiction to charge and collect sales taxes from their customers.

We urge support for the bipartisan Enzi-Durbin-Alexander *Market Place Fairness Act* (S. 1832), which would give state and local governments the option to collect the sales taxes they are already owed under current law from out-of-state businesses, rather than rely on customers to pay those taxes to the states. While brick-and-mortar retailers collect sales taxes from customers who make purchases in their stores, many online and catalog retailers do not collect these same taxes. This puts main street retailers at a five to ten percent competitive disadvantage to remote sellers. It is significant to note that customers are already required to pay taxes when they make online purchases, just like when they make purchases in a store; however, most taxpayers are not aware of this responsibility, and states and localities do not currently have the resources to enforce the payment of the tax. The *Market Place Fairness Act* does not impose a new tax, but would provide states and localities with a mechanism to require the collection of sales and use taxes on Internet and mail-order sales. This would help to level the playing field for brick and mortar stores on main street.

At a time when local governments are still facing tough choices to close budget gaps projected for fiscal years 2012 and 2013, collecting an estimated $23 billion owed in sales taxes a year would mean more money for investment in local infrastructure and basic services, just what the economy needs to generate more jobs. Although we have pushed for collection of remote sales taxes for over a decade, there is no time better than now for Congress to enact the *Market Place Fairness Act*, S.1832, into law.

Oppose federal initiatives that would grant certain industries preferential tax treatment and threaten the fiscal health of states and local governments

State and local governments continue to witness a growing parade of various industries actively urging Congress to preempt state and local government taxing authority of their particular industry. From the wireless industry, to the rental car industry, to online travel companies, these businesses are asking Congress for preferential tax treatment at the expense of local communities, individuals and families. The state and local government community strongly opposes any federal preemption of its taxing authority. If Congress were to grant any one industry's request for federally mandated tax favoritism it would open the door for other industries to request similar special exemptions or protections from state and local taxing authority. Such actions by Congress would cause great damage to the entire existence of independent state and local taxation authority in our system of federalism, as well as to the fiscal health of state and local governments - all while purporting to solve a host of problems that simply do not exist.

These preemption measures, particularly when taken together, would set an unprecedented and dangerous new standard for federal intervention into state and local government tax classifications. While they purport to address only 'discriminatory' taxation, their standard for federal intervention becomes that every industry sector and every service has to be taxed at the same rate. Such a standard for 'discriminatory' state and local taxes would mean, contrary to long-established precedent, that the federal government has the power to preempt all state and local tax classifications and to impose a federally-mandated state and local tax code of only a single rate for all business. This would result in the end of state and local tax classification authority; significantly undermining the ability of state and local governments to balance their budgets, and redistributing the tax burden among those taxpayers least able to bear the burden. The power of the federal government to preempt state and local taxes is ultimately the power to destroy state and local governments – a power that cannot be reconciled with our basic system of federalism.

Some examples of proposals that have been introduced that would preempt state and local taxes are as follows.

The Wireless Tax Fairness Act of 2011 would ban new state and local taxes on wireless communications for a period of 5 years. As justification for this special tax treatment, proponents of the measure use data that consistently inflates state and local tax burdens relative to other businesses by unfairly mixing taxes with user fees and failing to disclose that the industry pays virtually no corporate income taxes. Moreover, the wireless industry has yet to present any data indicating that state and local wireless taxes have had any adverse effect on wireless service subscribership, revenue or investment. Quite the contrary, the wireless industry has experienced 100% growth between 2006 and 2011, even as the industry complains about its state and local tax burden.

Furthermore, provider claims that state and local taxes hinder activities such as broadband deployment are completely without merit. In reality, provider decisions to deploy a network are purely economic; providers will only target areas of deployment where they will reap the greatest return on investment.

The End Discriminatory State Taxes for Automobile Renters Act of 2011 would preempt state and local governments' ability to impose 'discriminatory' taxes on automobile rentals and property related to renting automobiles. Yet, once again, the determination that a tax is 'discriminatory' is made without any reference to the factors that state and local policymakers use to evaluate local needs and the best manner to distribute the local tax burden, including offsetting exemptions that may be favorable to the rental car industry. Finally, the fundamental principle of federalism vests states and localities with the responsibility of providing services and raising funds to pay for those services. Fees may be placed on cars rented from airport locations that are used for capital improvements and tourism campaigns that directly benefit the rental car companies themselves. Rental car taxes are also imposed throughout the United States by cities, counties and states, with the proceeds used to pay for a variety of government services and programs.

Online Travel Companies (OTC) such as Expedia and Travelocity continue their behind the scenes efforts to have legislation favorable to their industry introduced at the federal level, at the expense of state and local taxpayers and the hotel industry. Such legislation would provide the OTC's with a tax loophole by allowing them to pay state and local taxes based on the lower, wholesale rate they pay hotels for room rentals, rather than on the higher, retail rate these companies charge customers, putting in-state hotels that remit taxes on the retail rate at a competitive disadvantage. It is estimated that state and local governments are losing $275 million to $400 million in revenue each year because OTC's fail to collect and remit to states and localities the appropriate amount of tax on hotel room bookings.

The Digital Goods and Services Tax Fairness Act of 2011 would regulate state and local governments' taxation of downloaded music, movies and online services. The bill would seek to ban 'multiple' and 'discriminatory' taxes on digital goods and services, even though there is **no** concrete evidence of this practice by state and local governments; another bill with a solution in search of a problem. Moreover, the measure could potentially disrupt fundamental features of state and local sales taxation and open up major tax-avoidance opportunities for some large multistate corporations. Furthermore, the *Internet Tax Freedom Act* enacted in 1998 already bans such multiple and discriminatory taxation of electronic commerce, including digital goods and services.

The Business Activity Tax Simplification Act of 2011 would redefine what constitutes physical presence to limit a state's ability to impose various taxes on businesses conducting activity within the state. Groups such as the National Governors Association have spoken out against the bill, characterizing it as an unwarranted intrusion into state affairs that will harm their ability to manage their finances during a critical and delicate time of economic recovery. The bill is estimated to cost states and localities $3 billion annually in revenue.

CONCLUSION

In summary, our several organizations understand the need for tax reform to address the rising federal deficit and to promote jobs and economic growth. As you discuss various tax reform proposals, we would strongly urge you to consider the impact any changes will have on critical infrastructure that residents in all local communities have come to depend on-- schools, transit systems, water and sewer systems, hospitals and roads and bridges. Local governments have been able to finance infrastructure projects at a reasonable interest rate through issuing tax-exempt municipal bonds. Without this type of financing, the cost to taxpayers would be significantly higher; and it would, in many cases, force local

governments to delay the financing of essential projects that create jobs and economic growth. We therefore strongly urge you to continue to maintain the federal income tax exemption for municipal bonds.

It is also important to adopt reforms that will allow local governments to retain authority over their own tax policy. We urge that you maintain the deductibility of personal state and local property, sales, and income taxes on federal tax returns. This recognizes the historic partnership that exists between federal state and local governments. The elimination or reduction of these deductions would only increase the cost of state and local taxes for citizens. We would also strongly urge you to immediately pass the *Market Place Fairness Act*, S. 1832, a bipartisan bill that would assist state and local governments collect $23 billion that is already owed to them on internet and mail-order sales. This would help state and local governments make needed investments in infrastructure improvements and other critical areas.

Finally, we would strongly urge you to oppose federal initiatives that would preempt state and local taxing authority and grant certain industries preferential tax treatment at the expense of other taxpayers. By granting any one industry's request for federally mandated favorable tax treatment, Congress would open the floodgate to many other similar requests, which would further erode state and local revenues and undermine their tax policy.

We appreciate the opportunity to submit this testimony on behalf of this country's counties, cities, and towns. If you have questions, please feel free to contact any of our association's legislative representatives.

Sincerely,

National Association of Counties - Michael Belarmino, 202-942-4254

National League of Cities - Lars Etzkorn, 202-626-3173

The United States Conference of Mayors - Larry Jones, 202-861-6709

International City/County Management Association – Joshua Franzel, 202-682-6104

Government Finance Officers Association - Susan Gaffney or Barrie Tabin Berger, 202-393-8020

NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

STATEMENT OF

SENATOR PAMELA ALTHOFF, ILLINOIS
DELEGATE SHEILA HIXSON, MARYLAND
SENATOR DEB PETERS, SOUTH DAKOTA
SENATOR CURT BRAMBLE, UTAH

NATIONAL CONFERENCE OF STATE LEGISLATURES'
EXECUTIVE COMMITTEE TASK FORCE ON STATE AND LOCAL TAXATION OF COMMUNICATIONS & ELECTRONIC COMMERCE

ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

REGARDING

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
10:00 AM
APRIL 25, 2012

COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 25, 2012

STATEMENT
OF
SENATOR PAMELA ALTHOFF, ILLINOIS
DELEGATE SHEILA HIXSON, MARYLAND
SENATOR DEB PETERS, SOUTH DAKOTA
SENATOR CURT BRAMBLE, UTAH
EXECUTIVE COMMITTEE TASK FORCE ON STATE & LOCAL
TAXATION OF COMMUNICATIONS AND ELECTRONIC COMMERCE
NATIONAL CONFERENCE OF STATE LEGISLATURES

Chairman Baucus, Ranking Member Hatch and members of the Finance Committee, we are pleased to submit this statement on behalf of the National Conference of State Legislatures (NCSL) and respectfully request that you submit it for the record. NCSL is the bipartisan national organization representing every state legislator from all of our nation's states, commonwealths, territories, possessions and the District of Columbia.

We are pleased to have the opportunity to inform you of the concerns state legislators have regarding state and local taxation in the new economy, specifically, the ability of state and local governments to collect the sales and use tax presently owed on transactions with out of state sellers, which ever increasingly is through electronic commerce.

NCSL Supports the Marketplace Fairness Act

We want to express our unconditional support for the Marketplace Fairness Act, S. 1832, as introduced by Senators Mike Enzi of Wyoming, Richard Durbin of Illinois, Lamar Alexander of Tennessee and 10 other of your colleagues from both parties. The Marketplace Fairness Act will provide those states that comply with the simplification

requirements outlined in the legislation, the authority to require remote sellers to collect those states' sales taxes.

Let us make this very clear, state legislators are not advocating any new or discriminatory taxes on electronic commerce. We desire, however, to establish a simplified sales and use tax collection system that allows sellers, regardless of where they are located, to collect and remit the legally owed sales and use taxes.

The new economy or if you prefer, electronic commerce, is not bound by state and local borders. This makes it critical to simplify the collection of state and local taxes to ensure a level playing field for all sellers in the marketplace, enhance economic development, and avoid discrimination based upon how a sale may be transacted. Government can not allow a tax system that was designed for an economy that was established almost 80 years ago, to be the deciding factor as to where our constituents make a transaction.

State legislators and governors have been seeking the ability to collect sales taxes on out of state transactions for many years. With the growth of electronic commerce, the current financial and economic situation, and the current effort to reduce the federal deficit, the urgency to act is even more immediate.

Current State Fiscal Challenges

As you know, the recent recession has had a debilitating impact on state budgets. Because states have a constitutional or statutory requirement to adopt balanced budgets on annual or biennial basis, between FY2008-FY2012, states closed a cumulative $527.7 billion budget gap, primarily through program reductions. While some states have begun to show an increase in revenues, other states are still facing budget deficits and sluggish revenues. In FY 2012, states had to close over $72 billion in budget deficits.

With the enactment of the federal Budget Control Act and the resulting sequestration, states are preparing for additional reductions in funding for many state federal programs. Our colleagues across the country will likely have to address $400 billion - $500 billion in reductions in federal assistance for many jointly administered and funded programs but we will do so having already reduced state budgets by over $500 billion during the recession. This will mean that states have $1 trillion less for many essential programs than states had only five years ago. Sequestration holds states to the same federal mandates, maintenance of efforts requirements and obligations as if there were no reductions in federal funds. For states, it is the worst of all possible outcomes. Raising taxes in a sluggish economy is not a viable option for most states; however, closing the loophole on sales tax collection could provide states with some additional revenue without having to raise new taxes.

According to the Center for Business and Economic Research at the University of Tennessee, in 2003, the estimated combined state and local revenue loss due to remote sales was between $15.5 billion and $16.1 billion. For electronic commerce sales alone, the estimated revenue loss was between $8.2 billion and $8.5 billion. The report from the University of Tennessee further estimates that the revenue loss will grow and that this year, 2012, the revenue loss for state and local governments could be as high as $23.3 billion, of which it is estimated that $11.4 billion would be from sales over the Internet. (See Table 1)

Table 1

Combined State & Local Revenue Losses from E-Commerce and All Remote Commerce – 2012

Source: Dr. Donald Bruce & Dr. William Fox, Center for Business & Economic Research University of Tennessee

	Total All Out of State Electronic Sales	Total All Out of State Sales
Alabama	170,400,000	347,734,399
Alaska	1,500,000	3,035,981
Arizona	369,800,000	708,628,254

Arkansas	113,900,000	236,311,930
California	1,904,500,000	4,159,667,947
Colorado	172,700,000	352,563,574
Connecticut	63,800,000	152,367,405
District of Columbia	35,500,000	72,517,182
Florida	**803,800,000**	**1,483,690,010**
Georgia	410,300,000	837,610,389
Hawaii	60,000,000	122,514,495
Idaho	**46,400,000**	**103,120,482**
Illinois	506,800,000	1,058,849,588
Indiana	195,300,000	398,817,708
Iowa	**88,700,000**	**181,012,560**
Kansas	**142,900,000**	**279,224,028**
Kentucky	109,900,000	224,484,309
Louisiana	395,900,000	808,311,357
Maine	**32,100,000**	**65,430,824**
Maryland	**184,100,000**	**375,944,240**
Massachusetts	**131,300,000**	**268,002,460**
Michigan	**141,500,000**	**288,954,339**
Minnesota	235,300,000	455,219,250
Mississippi	134,900,000	303,286,360
Missouri	210,700,000	430,191,928
Nebraska	61,300,000	118,052,068
Nevada	**168,900,000**	**344,923,618**
New Jersey	**202,500,000**	**413,390,425**
New Mexico	**120,500,000**	**245,989,786**
New York	**865,500,000**	**1,766,968,251**
North Carolina	213,800,000	436,517,492
North Dakota	**15,300,000**	**31,274,219**
Ohio	307,900,000	628,613,189
Oklahoma	**140,800,000**	**296,348,658**
Pennsylvania	345,900,000	706,241,542
Rhode Island	29,000,000	70,436,458
South Carolina	124,500,000	254,290,538
South Dakota	**29,800,000**	**60,826,849**
Tennessee	410,800,000	748,480,889
Texas	**870,400,000**	**1,777,090,593**
Utah	**88,500,000**	**180,658,961**
Vermont	25,100,000	44,759,329
Virginia	207,000,000	422,651,971
Washington	**281,900,000**	**540,968,704**
West Virginia	**50,600,000**	**103,284,206**
Wisconsin	142,100,000	289,006,114
Wyoming	**28,600,000**	**61,744,705**
Total	11,392,700,000	23,260,009,564

(States in bold have members on the Senate Finance Committee)

We believe that the Marketplace Fairness Act would allow the states to close this significant and growing loophole in our sales tax revenue and level the playing field for all sellers regardless of the medium used to conduct a transaction. S. 1832 also removes the burden from taxpayers in remitting their legally owed sales taxes on out of state sales. While the $23.3 billion in uncollected sales taxes will not match funding reductions from the federal government, it will provide states with some fiscal relief. In the words of Senator Roy Blunt of Missouri, a sponsor of this legislation, it is "fiscal relief for the states that does not cost the federal government a single dime."

Streamlined Sales and Use Tax Agreement

Over the past twelve years, state legislators, governors and sellers worked to develop a simplified and more uniform system of administering and collecting sales taxes, the Streamlined Sales and Use Tax Agreement (Agreement) that modernizes the current 80+ year old sales tax system. Twenty-four states have enacted legislation to comply with the Agreement and as of today, 21 of those states are full member and 3 states are associate members of the streamlined sales tax system.

Full Member States

Arkansas
Georgia
Indiana
Iowa
Kansas
Kentucky
Michigan
Minnesota
Nebraska
Nevada
New Jersey
North Carolina
North Dakota
Oklahoma
Rhode Island
South Dakota
Vermont
Washington
West Virginia
Wisconsin
Wyoming

Associate Member States

Ohio
Tennessee
Utah
(States in bold have members on the Senate Finance Committee)

S. 1832 would allow the 21 full member states listed above and all other states (including the 3 associate member states) that fully comply with the Agreement the authority to require all sellers not meeting the small business exemption to begin collecting these states sales and use taxes within 90 days of the enactment of this legislation. NCSL supports this provision and urges that Congress not require the states that have complied with the Agreement to have to enact any further requirements as they have already surpassed the other simplifications requirements in the legislation for all other states.

The Marketplace Fairness Act would also allow states that do not desire to participate in the streamlined sales tax system to enact certain minimum simplifications that would grant them collection authority six months after S.1832's enactment.

We also ask the members of this Committee from the 24 states listed above to respect and honor the decision made by your state legislatures and governors to join the streamlined sales tax system. We urge you to join Senators Enzi, Durbin and Alexander as sponsors and supporters of this legislation.

Small Business Exception

State legislators are concerned about the burden of government regulations and requirements on business. It is not our desire in requiring the collection of sales taxes for out of state sales to burden our constituents cleaning out their attics or sellers from placing their items up for sale on one of the many online auction sites. Those sales are

already exempt from sales taxes under existing so called "garage or yard sale" state provisions. We also value the small "mom and pop" type stores or new startup sellers that may have occasional sales across state borders and we do not want to stifle their efforts.

We support the small business exception in S. 1832, that is, no seller would be required to collect sales taxes for out of state transactions unless the seller has over $500,000 in out of state sales in a calendar year. The $500,000 level would not include sales in the state in which the seller has physical presence. We would urge caution in increasing the small business exception. Going above the $500,000 level would place many small main street merchants at a competitive disadvantage.

S. 1832 would also reduce the burden on all sellers by removing the liability for businesses collecting sales taxes, ensuring they are held harmless for calculations and collections under the information and certified technology provided by the states under the provisions of the Marketplace Fairness Act.

Myth – Requiring Out of State Sellers to Collect and Remit Is a New Tax

Some have argued that requiring out of state merchants to collect sales taxes from out of state buyers is a new tax. A study released by Jupiter Research in January 2003, *"Sales Tax Avoidance Is Imperative to Few Online Retailers and Ultimately Futile for All,"* found most people are unaware that they are not paying sales taxes when they make a purchase over the Internet. In the same study by Jupiter, only 4 percent of online buyers said that the collection of sales and use taxes would always affect their decision to buy online.

Online sellers already collect sales taxes where they have physical presence. The Marketplace Fairness Act does not require states to levy a sales tax on any product or

means of buying a product. The act merely corrects a growing tax avoidance problem and removes an inherent discrimination in our current tax laws. If Congress fails to pass the Marketplace Fairness Act in this session, states still reeling from the recession and facing another $500 billion in revenue reductions may have no alternatives but to seek to put in place new or higher taxes on income, property or businesses to fund essential services like public safety, education and highways.

Other State Tax Legislation

It is our understanding that the Committee will also hear testimony on other state tax issues such as the Business Activity Tax Simplification Act, the Mobile Workforce State Income Tax Fairness Act, the Wireless Tax Fairness Act and the Digital Goods and Services Tax Fairness Act. We believe the issues raised in these bills are worthy for discussion and NCSL has been working with the various industry representatives who support these bills to craft state solutions to the concerns these pieces of legislation seek to address. Unfortunately, the solution to all of these concerns requires either a reduction of existing revenues or reassignment of funds to different states or jurisdictions. Under the states' current fiscal predicament, it is difficult for our colleagues to find solutions to these issues without having to further reduce essential services.

While these issues should be addressed in state legislatures, we can understand the desire of industry representatives to seek a federal resolution. However, as these bills will affect state revenues and in some cases actually preempt state tax statutes, we respectfully request that any decisions on these state tax bills be held until the Marketplace Fairness Act has been enacted. NCSL is prepared to work with this Committee on these other state tax issues while our Conference continues to work with industry representatives to develop state solutions. NCSL is committed to ensuring fairness for all taxpayers.

Conclusion

Enactment of the Marketplace Fairness Act is a priority for the National Conference of State Legislatures and for our colleagues across the county. We call upon the members of Congress to support the efforts of their elected state policymakers, state legislators and governors, to collect sales and use taxes on out of state transactions legally owed by their state residents. Congress, as Senator Blunt has said, can provide fiscal relief, $23 billion in 2012, without having to find one offset or take any funds from the federal Treasury. We respectfully ask that you report the Marketplace Fairness Act to the full Senate.

For additional information or questions, please contact NCSL staff, Neal Osten, neal.osten@ncsl.org – 202-624-8660 or Max Behlke, max.behlke@ncsl.org – 202-624-3586.

Thank you.

NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

STATEMENT OF

REPRESENTATIVE DAN FLYNN, TEXAS

REPRESENTATIVE JAY KAUFMAN, MASSACHUSETTS

CO-CHAIRS, BUDGETS AND REVENUE COMMITTEE

ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

REGARDING

"Tax reform: What It means for State and Local Tax and Fiscal Policy"

TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

MAY 9, 2012

Chairman Baucus, Ranking Member Hatch and members of the Finance Committee, we submit the following statement on tax exempt financing on behalf of the National Conference of State Legislatures and respectfully request that you submit it for the official record. This statement is in addition to an April 25, 2012, submission by four of our colleagues on the Marketplace Fairness Act (S. 1832) also on behalf of NCSL.

We are pleased to have this opportunity to inform you of the concerns state legislators have regarding our experience with and the future of tax-exempt financing. As you undertake to reform the federal tax code either as a singular activity or in concert with deficit reduction efforts, we urge you to carefully consider the effect any changes you propose would have on state revenue authority and the states' ability to fund a wide array of public works' activities.

The federal tax code provides several preferential tax treatments for bonds issued by state and local governments for capital project purposes primarily. Among these treatments is the interest deduction for tax-exempt bonds, a provision that dates to the inception of the federal tax code. Among all of the tax treatments available for state and local government infrastructure projects, the interest deduction is the most beneficial and most productive mechanism for providing, maintaining and protecting investments in essential facilities. It provides the federal government significant leverage over vital infrastructure and capital facilities that we believe is not matched by other funding or revenue means.

State experience with preferential treatment of interest on municipal bonds offers many additional positive factors that should be considered in future deliberations. The overwhelming proportion of use of municipal bonds is infrastructure investment, not operating or other expenses. Most of these investments are carried out with electorate approval. They meet identified public needs. They produce debt service obligations that states meet readily. Municipal bonds are exceptional economic development and job creating/maintaining tools. They help to address what many reports have identified as pressing and unmet infrastructure and capital investment gaps.

We are well aware of other tools available for infrastructure development, notably private activity bonds, tax credit/direct subsidy bonds and federal grants in limited instances. None of these individually or collectively serves as an effective substitute for tax-exempt bonds. All of them can serve complementary purposes to tax-exempt financing depending upon circumstances.

NCSL believes that comprehensive, broad federal deficit reduction is needed. We believe that states should contribute proportionately to any deficit reduction strategy as long as the federal deficit is not exported to states through new mandates, cost shifts or unbalanced modifications to entitlement and mandatory programs. We also believe there are compelling reasons for

protecting low-income programs from deficit reduction efforts and for subsidizing vigorous economic investments, particularly public works projects carried out through tax-exempt financing.

The linkages between federal and state tax systems and related policies are many. They are often overlooked or ignored. For example, we have reviewed numerous deficit reduction reports, the bulk of which virtually fail to recognize or to pinpoint these linkages. The actions you take will have consequences for states and state authority. We are hopeful these actions will have positive consequences. We are pleased you have conducted this hearing and look forward to participating directly in a collaborative effort to reform the federal tax code and to provide effective tools for building and maintaining infrastructure.

Great Public Schools for Every Student

Testimony Submitted for the Record
United States Senate
Committee on Finance

Hearing on
Tax Reform: What It Means for State and Local Tax and Fiscal Policy
April 25, 2012

Submitted by:
The National Education Association
1201 16th Street, NW
Washington, DC 20036

Chairman Baucus and Members of the Finance Committee. On behalf of the 3.2 million members of the National Education Association (NEA), we thank you for the opportunity to submit these comments in support of the *Marketplace Fairness Act* for the record in conjunction with the hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy."

NEA strongly supports the *Marketplace Fairness Act*. This bipartisan legislation would remedy a long-standing inequity and finally allow states and local governments to collect sales tax from remote sellers. In so doing, it would help states stop the erosion of their tax base and provide needed resources for education and other critical priorities.

States face an unprecedented fiscal crisis worsened because they have limited authority to collect taxes on sales into their states. As a result, schools, police, firefighters, health care, emergency responders, roads, public transportation, and parks are being deprived of critical revenues. These uncollected revenues could help offset growing budget gaps in almost every state – over $27 billion in much needed revenues is not being collected.

In most states, brick and mortar stores are placed at a competitive disadvantage because they must collect sales taxes while sellers located outside their states do not. The U.S. Supreme Court (*Quill Corp. v. North Dakota*) said that Congress has the authority to allow states to require remote sellers (a retailer that does not have a physical presence in a state) to collect taxes. Small businesses have historically always been one of the main engines of job creation. In fact, during the past decade, small businesses created more than 60 percent of net private-sector jobs. We need to ensure that they not only survive, but thrive and help rebuild the economy.

The *Marketplace Fairness Act* will also help provide an alternate source of local revenue to counter dramatic losses from the housing crisis. Local property tax revenues, which account for 40 percent of public education funding, continue to suffer from the foreclosure

crisis. Combined with federal and state spending cuts, these losses have resulted in substantial reductions in core education programs and services. The *Marketplace Fairness Act* will help offset these losses.

The bill will not impact the *Internet Tax Freedom Act*, nor will it create new taxes or increase existing taxes. It does not require any state to collect sales and use tax. Consumers are required under existing state laws to pay sales and use taxes on the goods they purchase. Consumers can be audited and charged with penalties for failing to pay sales and use taxes, but too often states are unable to enforce this requirement.

The *Marketplace Fairness Act* will allow the forty-four states and the District of Columbia that collect sales tax to better address fiscal shortfalls. The bill will help ensure desperately needed resources for education. We encourage your support for this important legislation.

Thank you for your consideration of these comments.

NATIONAL FOREIGN TRADE COUNCIL, INC.

1625 K STREET, NW, WASHINGTON, DC 20006-1604

TEL: (202) 887-0278 FAX: (202) 452-8160

Comments of the National Foreign Trade Council
On the Business Activity Tax Simplification Act
Before the Senate Finance hearing titled: "Tax Reform: What it Means for State and Local Tax and Fiscal Policy."
Held on April 25, 2012

The National Foreign Trade Council (NFTC), organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and the NFTC therefore seeks to foster an environment in which U.S. businesses can be dynamic and effective competitors in the domestic an international business arena. The NFTC appreciates the Senate Finance Committee holding a hearing on state and local fiscal policy and strongly supports the Business Activity Tax Simplification Act of 2011, ("BATSA"), and respectfully asks that you consider the BATSA as you move forward in the tax reform discussion.

A bill has been introduced in the House by Representatives Bob Goodlatte (R-VA) and Bobby Scott (D-VA), (H.R. 1439) that has strong bipartisan support among members of the House Judiciary Committee. The bill would clarify the constitutional nexus standard governing state assessment of corporate income taxes and other direct taxes on a business (it would have no impact on sales and use or other non-income-based taxes). Specifically, the bill articulates a bright-line physical presence standard that would ensure that both states and businesses understand the tax rules under which they are operating, which is particularly important for businesses with customers in many states that all have separate business tax regimes and standards.

The NFTC has a particular interest in supporting the BATSA bill, as the state's actions in pursuing taxes where there is a lack of physical presence of the taxpayer has, and will, cause uncertainty and widespread litigation, so much so that it has, and will, create a chilling effect on not only inter-state but also international commerce. The physical presence standard is articulated as a "permanent establishment standard" in our bi-lateral tax treaties and under OECD guidelines. In other words, physical presence is the international norm. Adoption of a more nebulous standard by the States undermines these international treaties. Moreover, a violation of the international norms by the imposition of business activity taxes undermines the United States' negotiating position with foreign nations. A new tax structure is likely to invite reciprocal, aggressive tactics by foreign taxing authorities, seriously compromising the competitive leadership of U.S. businesses. Under the foreign tax credit system that has long been a cornerstone of our income tax system, this would in effect force the United States to cede to other nations' tax jurisdiction over U.S. activities that have no physical presence abroad.

BATSA would ensure fairness, minimize costly litigation and create the kind of legally certain and stable environment that encourages businesses to make investments, expand interstate commerce and create new jobs. At the same time, the bill would ensure that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections.

Thank you once again for holding this hearing... We look forward to working with you, your staff and all members of the Senate Finance Committee on the Business Activity Tax Simplification Act

Hearing Statement of the
National Governors Association

Committee on Finance
United States Senate

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

Chairman Baucus, Ranking Member Hatch, and members of the committee, the nation's governors appreciate your interest in considering how federal legislation may impact state taxation. For governors, the core principle Congress should adhere to regarding state taxation is simple: decisions about state revenue systems and state taxation should be made by elected officials in the states, not the federal government.

This principle is particularly important as states continue to emerge from the recession. Unlike the federal government, states must balance their budgets. This requires states to make up for lost or decreased revenues by cutting spending and services or raising revenues.

As this committee, and Congress as a whole, considers legislation to spur the economy, create jobs, promote competitiveness or reform taxes, it should do so with an eye towards the critical role states play in promoting recovery. Specifically, any federal legislation that would impact state taxes or taxing authority should follow the guidelines of do no harm, preserve flexibility, be clear and respect state sovereignty.

Fiscal Condition of States

As Congress examines the possible effects of federal tax reform on state governments, it is important to review the current fiscal condition of states. Since the depth of the recession, the overall fiscal condition of states has improved, but states continue to face fiscal pressures that are slowing their recovery. In fact, for many states, aggregate state revenues and spending remain below those recorded in 2008. Since that time, states have filled more than $325 billion in budget gaps through cuts to spending and services and revenue increases and yet still face another $30 billion in gaps for fiscal year 2013.

Part of states' fiscal challenges come from programs such as Medicaid. Although revenues and expenditures are growing slowly, Medicaid spending is outpacing revenue growth. This growth is fueled by increased enrollments, the end of federal funds associated with the enhanced matching rate of state costs from the Recovery Act, and higher per capita health care costs in general. In many states, Medicaid has overtaken K-12 education as the largest single expense item in state budgets.

States also face a fiscal "squeeze" from both federal and local governments. Widely anticipated declines in federal support will certainly have an impact on resources available to states, as will strong pressure from local governments to increase aid while restoring previous cuts. Although not every state reduced the amount of aid provided to local governments, overall, states redirected previously allocated aid to local governments to the general fund to help satisfy the increasing demand for state services in the face of slowly rising revenues.

What this means for Congress is that any tax changes at the federal level must be measured against their fiscal impact at the state level. Federal policies that interfere with states' authority to manage their fiscal systems risk weakening states' fiscal condition and further prolonging their economic recovery.

Guidelines for federal legislation related to state taxation

Governors believe federal action should favor the preservation of state sovereignty when legislating or regulating activity in the states. This is particularly true when it comes to actions that affect the ability of states to manage their revenue systems. The independent ability of states to develop and manage their own revenue systems is a basic tenet of our federal system. Therefore, the federal government should avoid legislation and regulations that would serve to preempt or prohibit, either directly or indirectly, sources of state revenues or state taxation methods that are otherwise constitutional.

Since adoption of the U.S. Constitution, Congress has generally respected state sovereignty with regard to state taxes. Unfortunately, that trend has begun to change over the last few years as Congress has increasingly restricted the rights of states to determine their own tax structure.

As this committee considers whether to take up legislation related to state taxation, governors encourage the committee to review all proposals in light of the following guidelines:

- **Do no harm**: Legislation dealing with state taxing authority should not disproportionately reduce existing state revenues. This principle is especially important at a time when states are cutting core services to meet balanced budget requirements. Federal unfunded mandates or limits on state authority will only exacerbate the fiscal problems states currently face.

- **Preserve flexibility**: The recession forced all governors and states to ask fundamental questions about the role of government. These questions have led to changes at the state level that could have long-term, positive effects on the delivery of services, modernizing revenue systems and holding government accountable. States should not be hindered in their pursuit of these reforms by federal legislation that restricts a state's authority to act.

- **Be clear**: Federal legislation, especially in the context of state taxation, should be clear to limit ambiguity or the need for expensive and time-consuming litigation.

- **Respect state sovereignty:** The independent ability of states to develop their own revenue systems is a basic tenet of self-government and our federalist system. The federal government should not enact any legislation that would preempt, either directly or indirectly, sources of state revenues, state tax bases, or state taxation methods without the input and support of states.

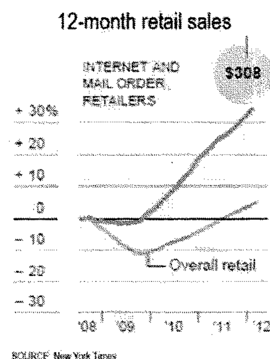
Marketplace Fairness:

The National Governors Association (NGA) urges Congress to honor these guidelines and level the playing field between out-of-state and in-state retailers by authorizing states to require remote vendors to collect state sales taxes.

Specifically, governors are encouraged by the introduction of the "Marketplace Fairness Act" (S. 1832), and the "Marketplace Equity Act," (H.R. 3179). Although the two bills are not identical, each bill would authorize states to require the collection of sales taxes in return for the implementation of tax simplifications that can help all businesses and create fairer competition.

For states, each bill represents the opportunity to collect more than $22 billion in sales taxes that are currently owed states. The ability of consumers to avoid paying appropriate state sales taxes was permitted 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. 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 $308 billion this past year. 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.



NGA calls on Congress to examine the different proposals pending before it and move ahead with legislation that will help states modernize their sales tax systems and bring them into the 21st century. Specifically, NGA recommends that the legislation include a specific and clear grant of authority to states to require remote vendors to collect sales taxes; provide a small business exception that exempts genuinely small businesses from collection requirements; avoid impinging on states' authority to establish or remove a tax or set rates it finds appropriate; and not limit state authority over other forms of state taxation.

Background:
The Streamlined Sales and Use Tax Project (Project) was initiated by NGA and the National Conference of State Legislatures in the fall of 1999. The goal of the Project was to find solutions for the complexity in state sales tax systems that resulted in the U.S. Supreme Court holding that a state may not require a remote seller without a physical presence in the state to collect tax on sales into the state.

As a result of the Supreme Court decisions, local brick-and-mortar stores operate at a competitive disadvantage with remote sellers who do not collect sales taxes. Local stores find themselves serving as showrooms for Internet and catalog sellers. Prospective customers check out the merchandise locally then buy the product online or through a catalog to avoid paying sales tax.

To address this problem, the Project generated the Streamlined Sales and Use Tax Agreement (SSTA), 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. The SSTA minimizes costs and administrative burdens on retailers that collect sales tax, particularly retailers operating in multiple states. It also encourages "remote sellers" selling over

the Internet and by mail order to voluntarily collect tax on sales to customers living in states that comply with the SSTA.

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. This amount, however, pales in comparison to what could be collected under a nationwide system authorized by Congress through federal legislation.

Federal Legislation:
NGA has supported several different bills over the years to grant states collection authority over remote vendors. As stated above, NGA's support for legislation is not tied to specific legislation, but to core elements that governors believe should be part of any federal grant of authority to states.

First, federal legislation must specifically grant authority to states to require remote vendors to collect sales and use taxes on sales of taxable products and services delivered into their jurisdiction. More importantly, since the grant of authority is tied to meeting certain simplifications, the legislation should recognize the efforts of states which are compliant with the SSTA by granting them the authority to collect immediately. If an alternate path is offered for non-SSTA states, the requirements must be clear so as to avoid litigation when the state makes changes to gain collection authority.

Second, the legislation should include a small business exception that exempts genuinely small sellers from the collection requirements. While governors have never specified a level for the small business exception, the size of the exception should be sufficient to relieve the smallest businesses from collection authority, but small enough to ensure the exception does not swallow the rule. Compliance with the law will be made easier by software made available to small businesses to aid compliance. Any exception will preserve a portion of the tax collection gap states are working to close. NGA encourages Congress to set a low small business exception while allowing states to increase the exception as appropriate.

Third, the legislation should not dictate rates or mandate the existence or removal of a sales tax. The ability of a state to manage its own fiscal system is at the core of state sovereignty and our federal system. States should be given maximum flexibility to determine the structure and level of taxation while meeting certain simplifications that promote efficiency and enhance the ability of sellers to collect and remit sales taxes.

Additional tax legislation:
NGA does not favor combining federal legislation like the Marketplace Fairness Act with bills that would restrict state authority or that fail to meet governors' recommended guidelines.

A clear example of the type of legislation NGA opposes is the Business Activity Tax Simplification Act (H.R. 1439); a House bill that would mandate a physical presence nexus standard for all business activity taxes. Not only would the bill harm states by significantly reducing revenues, its exemptions would also lead to endless litigation, eliminate state authority

to tax companies earning profits in their states and favor businesses profitable enough to afford aggressive tax planning over smaller, local businesses.

Likewise, bills that limit or prohibit states' ability to tax are blunt instruments that directly interfere with state sovereignty. Even bills that purport to establish uniform rules for taxation must be carefully crafted so as not to unwittingly interfere with state authority. Bills such as S. 971, the Digital Goods and Services Tax Fairness Act claim to establish clear rules for sourcing transactions of digital goods, but they fail to adequately define the types of taxation subject to the bill and could have unintended consequences for states. This is the type of bill where Congress should insist that industry and states to work together to find common ground and craft workable legislation that has the support of industry, states and consumers.

Tax treatment of interest on municipal bonds and other public finance matters:
In addition to legislation that could affect states' authority to tax, Congress should carefully consider the impact of changes to federal tax provisions that benefit states. For example, given the post-recession inventory of unmet infrastructure needs, proposals to adjust the current interest deduction for tax-exempt bonds would threaten the primary mechanism for funding the nation's public works.

Through the tax exemption, the federal government provides critical support for the development and maintenance of essential facilities and services, which it cannot reasonably deliver by any other means. Unlike corporate bonds, the default rate in the approximately $2.8 trillion municipal bond market remains well below one percent. Long-term municipal bonds generally fund infrastructure investments, not operating expenses. Aggregate interest payments on state and local debt account for less than five percent of current expenditures, and aggregate state debt load as a share of GDP, while rising somewhat during the recession, remains within its historical range (12-18 percent).

No effective substitute for tax-exempt bonds exists. Investor demand for alternatives like tax credit bonds is insufficient, at best. Taxable direct subsidy bonds permitted for issue during 2009 and 2010 only complemented tax-exempt bonds, but only when the taxable bonds provided a subsidy far greater than the benefit to investors from interest deductibility.

If municipal bond interest were taxable, or if the federal tax-exempt status on state and local bonds were capped or lifted, the cost of borrowing, and therefore of financing infrastructure would rise for states. Ultimately, this cost would be borne by taxpayers through reduced infrastructure spending, higher taxes, or both.

Governors should be at the negotiating table and the impact of federal tax decisions on states given the highest consideration as federal policymakers consider federal tax reform. Shifting the federal system of income taxation to something else like a sales or consumption tax could damage administrative viability and limit state control of their tax systems because of federal encroachment into the traditional tax base of states. Corporate and individual income tax reform could also have consequences for state collections since state taxes are often linked to federal definitions. Finally, ending certain federal tax deductions for state and local income, property or sales taxes must be carefully considered to avoid unintended consequences.

Conclusion:

Congress, through its authority under the Commerce Clause of the U.S. Constitution, has broad authority that can impact state taxation. The key question is when and how should that authority be used. The Marketplace Fairness Act represents the type of collaborative solution that is possible when states, industry and Congress work together to address difficult tax issues that require federal action.

Governors believe that the ability of states to develop and manage their fiscal systems is a core element of sovereignty – one that should not be interfered with unless absolutely necessary to preserve interstate commerce. Governors urge Congress to support bills like the Marketplace Fairness Act and to encourage all stakeholders to work together to find mutually beneficial solutions to issues that could affect state and local taxation.

Testimony of Thomas J. Dammrich, President

National Marine Manufacturers Association

Chicago, IL

Submitted to the United States Senate Finance Committee

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

Mr. Chairman, Ranking Member Hatch, Members of the Senate Finance Committee. We appreciate the opportunity to submit this testimony to you as you consider the proper relationship between manufacturers and States that seek to assess income and similar taxes on nonresident companies, what is commonly referred to as the "Business Activity Tax Nexus" issue. The National Marine Manufacturers Association (NMMA) is the largest trade association representing manufacturers in the recreational boating industry. If you have heard of a recreational boat brand, we probably represent it. If you have heard of a marine engine brand, we probably represent it. If you have heard of a trailer or boating accessory manufacturer, we probably represent them. Our businesses generated over $30 billion in sales and services in 2010 and contributed over $70 billion to the US economy that year. In 2011 recreational boating supported 353,000 American jobs. In 2010 our manufacturers provided a positive balance of trade for the United States, exporting over $573 million more in boats and marine engines than were imported. In short, the recreational marine industry is a powerful part of the US economy, providing good-paying jobs for hard-working Americans and offering untold opportunities for middle-class Americans to get outdoors and enjoy this great country of ours.

Manufacturers in the recreational boating community, whether they make boats or engines or trailers or accessories, are more than willing to pay their fair share of taxes, providing those taxes are equitably levied by the jurisdictions in which they manufacture their products or in which they have some type of physical presence. What they and many other American businesses object to is States that believe they have a right to tax a manufacturer who has only the most tangential connection to the taxing State. We understand that any State faces the great temptation of raising funds from those who do not vote in its elections, but this "tax nexus" business has become completely absurd. Massachusetts, for example, claims that a business has established the necessary "nexus" for corporate income tax purposes if that business has vehicles that travel through Massachusetts more than twelve times in one year, even if it has no employee, office, or inventory in Massachusetts. Massachusetts does not require that the vehicles make deliveries or pick-ups in Massachusetts, only that they travel through the State on their way to somewhere else. Presumably the company or contract carriers pay the proper Massachusetts fuel taxes, so this is not about road building and maintenance. It is about a tax grab, pure and simple, in a State where revolutionaries proudly dumped tea into a harbor in 1773 because they objected to what they thought was unfair taxation. Does the Massachusetts transit-based tax make sense to anyone on this committee? I think not.

It is not the Commonwealth of Massachusetts, however, but the State of New Jersey, that regularly stops trucks moving along its highways and demands that payment of business activity taxes--based on a field survey--be wired to it before it will release the truck and cargo. As Joan C. Maxwell, President of Regulator Marine of Edenton, NC, stated in her testimony before a House committee this past year, "There is one state I am aware of that has a reputation (in the marine industry) for stopping loads and holding them until the Nexus taxes are paid. As a small company, Regulator cannot afford to risk boats not reaching their destination in a timely manner. Small businesses like Regulator literally operate off of cash flow. To mitigate some of the risk of stopped loads, Regulator ships on contract carriers in this state when use of its own equipment would be less expensive." What this means, Mr. Chairman, Ranking Member Hatch, and Members of the committee, is that this US boat manufacturer has been forced to make a business decision that costs it money based not on sound business practices, but on the uncertainty that results from a particular State's penchant for grabbing out-of-state boat shipments and holding them for ransom. And that, I think, is simply wrong and represents a problem that needs to be fixed.

Michigan does not grab boats along the roadways. It simply sends tax bills through the US mail. Michigan claims that actively soliciting business in the State triggers the nexus required for the Michigan gross receipts tax to kick in. Monterey Boats of Williston, FL, discovered last year that Michigan will sometimes go after a manufacturer even when it has not actively solicited business in Michigan. Michigan apparently secured a copy of Monterey's federal tax return and slapped them with a "gross receipts tax" in the amount of $376,000—far more than the total worth of the boats that Monterey sold in Michigan that year. Monterey Boats, it should be pointed out, has no property in Michigan, no sales offices in Michigan, no agents in Michigan, and no employees in Michigan. Mark Ducharme of Monterey Boats told the *St. Petersburg Times* newspaper that, "The company's sales in the state in question [Michigan] for the year in question were $100,000 less than the surprise tax assessment." Let me repeat that statement: "The company's sales in the state in question for the year in question were $100,000 less than the surprise tax assessment." Now, how could any reasonable person maintain that taxing a business more than the total value of business transacted in that State is anything but totally unfair and completely indefensible?

It should be easy for the Members of this committee to see the possibilities here: a business could literally be taxed to death by States that are hungry for revenue from any and all sources if each State where the business has a customer decided to tax the gross receipts of the company in question. The fact that Michigan is so far the only State that is going after Monterey Boats in this fashion does not mean that other States where Monterey Boats has made a few sales could not also come after them and assert a right to tax its income. Other States could cast covetous eyes on the amount of tax that Michigan is claiming from this small company and decide to do likewise. Monterey will undoubtedly contest this tax bill, and it might secure full or partial abatement of it, but Monterey will lose, regardless of the outcome, as it will have run up significant legal fees fighting the State of Michigan. This very large tax bill was not part of Monterey's budget planning for the year 2012, and it may well hinder this manufacturer as they attempt to survive in a super-competitive environment and keep their 250 employees working steadily and producing more of their fine boats.

I could go on with other examples where States have claimed a dubious nexus as they sought to collect taxes on out-of-state businesses, but I am confident that you understand my point. Unless

the Congress steps in to clarify that the U.S. Constitution requires physical presence nexus and sets forth a clear bright-line test for what constitutes physical presence, then we will continue to have a jumble of impossible-to-plan-for laws, regulations and enforcement actions that vary across the fifty States. And that, Mr. Chairman, Ranking Member Hatch, and other Members of this committee, is what needs to be fixed by the Congress.

We are not asking you to develop this legislation out of nowhere. There is, in fact, legislation that has been reported favorably by the House Judiciary Committee that we believe would solve the problem. This legislation, the "Business Activity Tax Simplification Act," or "BATSA," was introduced on a bipartisan basis by Reps. Goodlatte (R-VA) and Scott (D-VA), and it now has eleven co-sponsors in the House. This bill, H.R. 1439, is a good place to start the deliberations, as it provides that a business must have some type of physical presence in a given State—excluding a *de minimis* presence of less than 14 days during a taxable year—before a State would be permitted to impose a tax on the business. We believe this is a reasonable standard that businesses can use to plan for their tax liabilities so that they are not hit unexpectedly with large tax bills from States in which they have no physical presence.

BATSA, or such version of it as you develop, would end the confusion that exists as a result of contradictory State court decisions and the refusal of the U.S. Supreme Court to decide the issue. It would apply to business activity taxes, including income and franchise taxes, but it would not apply to transaction taxes such as sales taxes. We believe it is fair for a State to tax in-state businesses and those that regularly conduct business there, but we believe it is grossly unfair for any State to reach out as the ones mentioned above have done and assert that simply passing through the State or selling a few products in the State allows a tax based on total, country-wide revenue.

Article I, Section 8 of the U.S. Constitution provides Congress with the power "to regulate Commerce . . . among the several States," and it is that power which we call upon the Congress to exercise. What we have seen is that the U.S. Supreme Court has been quite reluctant to involve itself in setting the parameters of State interference with interstate commerce. As recently as last fall the Supreme Court declined to hear a case involving Kentucky Fried Chicken (KFC) and the State of Iowa. Iowa had claimed that KFC, which owned no restaurants in Iowa and directly employed no persons in that State, could be forced to pay income taxes on royalties it received from Iowa franchisees. Because the U.S. Supreme Court refused to hear the case, KFC was left with an Iowa Supreme Court decision holding that the fried chicken-seller would owe $250,000 in back-taxes to the State. What we as manufacturers need is for the Congress to step forward, assert its primacy in the area of interstate commerce—which this most certainly is—and clarify when a State can tax a business with little or no physical presence in that State. This is certainly not a partisan issue. It is a basic fairness issue, and we understand that a previous iteration of the bill has been scored as federal revenue-positive by the Congressional Budget Office. There is no reason to delay any longer, Mr. Chairman, Ranking Member Hatch, Members of this committee. The time is right to end unfair business taxation and to make it clear that taxing out-of-state entities can only be done within certain well-defined limits. American businesses are not asking for a hand-out from the Congress, only a fair and level playing field, free from the unexpected tax surprises that I have described to you today. Thank you for your time.

Submission of the National Retail Federation

to the

Senate Committee on Finance

Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy

April 25, 2012

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As the world's largest retail trade association and the voice of retail worldwide, NRF represents retailers of all types and sizes, including chain restaurants and industry partners, from the United States and more than 45 countries abroad. Retailers operate more than 3.6 million U.S. establishments that support one in four U.S. jobs – 42 million working Americans. Contributing $2.5 trillion to annual GDP, retail is a daily barometer for the nation's economy. NRF's Retail Means Jobs campaign emphasizes the economic importance of retail and encourages policymakers to support a Jobs, Innovation and Consumer Value Agenda aimed at boosting economic growth and job creation. www.nrf.com

Summary of Comments

Members of the National Retail Federation believe that Congress must resolve the Constitutional questions posed by the *Quill* decision in a fashion which promotes a level playing field among retail competitors. As retailing evolves and Internet sales become a more prominent portion of total retail sales, it is critical that Congress address the sales tax collection discrimination that exists between brick-and-mortar and remote retailers.

Brick-and-mortar retailers compete vigorously with each other and with remote retailers for market share. Different retailers have different strategies for going to market, but one feature is beyond a retailer's control: only some competitors collect sales taxes. This disadvantage is not created by the marketplace, but rather it is imposed by the current state of the law following the *Quill* decision, stifling retailers across the country.

In addition to the pricing disadvantage caused by sales tax being included in the cost of the purchase from the brick-and-mortar store, local stores also bear a significant compliance burden for collecting the tax. Compliance costs for small retailers are extremely high, placing them at more of a competitive disadvantage.[1] The national average annual state and local retail compliance cost in 2003 was 3 percent of sales tax collected for all retailers: 13.47 percent for small retailers, 5.20 percent for medium retailers, and 2.17 percent for large retailers.[2]

Brick-and-mortar retailers are major contributors to the health of local communities and should not be placed at a disadvantage compared to remote sellers that have no local presence. Brick-and-mortar sellers employ people in the community, pay state and local income taxes, as well as property taxes. They sponsor local causes like the Little League, soccer, and Booster Clubs.

Simplification is a key component for reform of the sales tax collection system for both brick-and-mortar sellers and remote sellers who voluntarily collect sales tax. Many members of the NRF voluntarily collect sales tax on remote sales into states where they do not have a physical presence. In many instances, the retailers that voluntarily collect sales tax do so only from states that have adopted the Streamlined Sales and Use Tax Agreement ("SSUTA") because of the Agreement's simplified collection requirements.

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[1] PricewaterhouseCoopers LLP, *Retail Sales Tax Compliance Costs: A National Estimate Volume One: Main Report*, April 2006. That study defined "small retailers" as having less than $1 million in annual retail sales.
[2] *Id.* That study defined "medium retailers" has having over $1 million and up to $10 million in annual retail sales, and "large retailers" as having over $10 million in annual retail sales.

Granting states the authority to collect sales tax from remote sellers will add significant resources to state budgets to support essential local services including teachers, police officers, firefighters and ambulance crews. Remote sales include e-commerce, mail order sales, telephone orders, and deliveries made across state lines. By 2012, total e-commerce sales are estimated to reach $4 trillion dollars.[3] Annual national state and local sales tax losses on e-commerce alone are conservatively expected to grow to $11.4 billion by 2012 for a six-year total loss of $52 billion.[4]

NRF is encouraged by this Committee's interest in this issue as well as the several legislative proposals that have been introduced this Congress to address sales tax fairness, especially the Marketplace Fairness Act, S. 1832, introduced by Senator Enzi, Senator Durbin, Senator Alexander, and Senator Johnson. NRF supports Congress granting states remote collection authority with simplifications that ensure retailers are not unduly burdened by collecting and remitting sales taxes. Congress needs to pass S. 1832 this year.

Background

Consumption taxes are imposed on the sale or use of goods and some services that are subject to tax. It is a tax on the consumer and is imposed where the consumption takes place. So all sales in a given state are subject to the sales tax, regardless of whether the sale occurs in a store in the state or in the home of a resident of the state through their computer or telephone. If Congress permits the state to only *collect* the sales tax on sales that occur in stores in that state and not sales that occur over the computer in that state, than Congress would be discouraging *intra-state* commerce because retailers that sell goods within the state are at a competitive disadvantage vis-à-vis remote sellers.

In 1992, the U.S. Supreme Court ruled in *Quill v. North Dakota* that "remote sellers" — a category that includes mail-order, telephone and Internet merchants — cannot be required to collect sales tax from customers in states where the merchant does not have a physical presence or "nexus." The court reasoned that the sales tax system was too complex for a merchant to know what sales tax to charge an out-of-state customer — 45 states and 7,600 local jurisdictions collect sales tax, each with its own rates, lists of taxable items and definitions of taxable items. But the justices suggested that sales tax collection could be required if the system were simplified and Congress authorized the collection authority because remote sellers are "purposely availing" themselves to a jurisdiction's authority by engaging in commerce.

In late 1999, in response to the Supreme Court ruling, states and the business community, including NRF, began the Streamlined Sales Tax Project, with an aim toward significant simplification of state sales tax systems. Since then, a baseline multi-state agreement, the SSUTA, which includes common definitions, uniform processes and procedures, and significantly simplified administrative features has been passed by 24 states (21 full member states and 3 associate member states), establishing the necessary groundwork for action by Congress. The 21 full member states with voting rights include: Arkansas, Iowa, Indiana, Georgia, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North

[3] Donald Bruce, William F. Fox, and LeAnn Luna, *State and Local Government Sales Tax Revenue Losses from Electronic Commerce*, University of Tennessee, April 2009, available at http://cber.utk.edu/ecomm/ecom0409.pdf.
[4] *Id.*

Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont, Washington, West Virginia, Wisconsin and Wyoming. Three associate member states with negotiating authority but delayed voting rights are Ohio, Tennessee and Utah. Delegates from the 24 states administer the SSUTA through the Streamlined Sales Tax Governing Board.

As electronic commerce continues to grow, so will the losses to state and local revenues.[5] In fiscal year 2012, it is conservatively estimated that state and local governments stand to lose at least $23.2 billion in uncollected sales and use taxes from remote transactions, with over $11.4 billion uncollected from e-commerce transactions.[6] General sales taxes make up roughly one third of state tax revenue.[7]

The Effect of Simplification on Retailers

Through adoption of the SSUTA, 24 states have already implemented significant simplification of their sales tax laws. This simplification has incentivized collection of sales tax by many remote sellers that currently are not required to collect sales taxes. For example, a large regional retailer with a significant national business through their Internet channel has even made the decision to collect sales tax on remote sales but only in states that have adopted the SSUTA.

Many remote sellers recognize that collecting sales taxes may be a more efficient approach to dealing with the realities of their constantly evolving business model. Nonetheless, their good faith effort to collect sales tax would be undermined by collection authority that did not include significant simplification steps.

While NRF believes that a modest small seller exemption for remote sales is appropriate, raising the level too high will only exacerbate the potential for inequity between a small remote retailer that does not have to collect any taxes and a local small retail competitor who must collect sales taxes on the first dollar of sales. Congress should resist the temptation to envision that a small seller exemption is the easy answer to meaningful small business regulatory relief.

Current Sales Tax Fairness Legislation before Congress

The two leading bills introduced this Congress to address the issue of sales tax fairness are the Marketplace Fairness Act and the Marketplace Equity Act.

(1) Marketplace Fairness Act of 2011, S.1832, sponsored by Senators Enzi, Durbin, Alexander and Tim Johnson provides a path for states to collect sales tax that incorporates a combination of either nine simplification steps or adoption of the SSUTA. The Marketplace Fairness Act exempts remote sellers with less than $500,000 in remote U.S. sales, requires a single audit by states and localities within a state, requires a single state tax rate based on the destination of the sale, states must establish certification procedures for software and service providers (to calculate

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[5] *Id.*
[6] *Id.*
[7] Lucy Dadayan and Robert B. Ward, *State Revenue Report*, The Nelson A. Rockefeller Institute of Government, Oct. 2011, No. 85, available at http://www.rockinst.org/pdf/government_finance/state_revenue_report/2011-10-26-SRR_85.pdf.

rates), and gives remote sellers liability protection for relying on incorrect information supplied by service providers.

(2) Marketplace Equity Act of 2011, H.R. 3179, sponsored by Representatives Womack and Speier allows states to collect sales taxes from remote sellers if they meet three minimum simplification requirements. These three simplification requirements may be met in an interstate agreement, presumably including the SSUTA. Sellers with less than $1 million in remote U.S. sales or $100,000 in remote sales into a particular state are exempted. The three simplification steps are: (1) a single revenue authority within a state for submission of a return; (2) a single tax base set by the state; and (3) the state must choose a single tax rate from three choices: a blended rate of state and locality rates, the maximum state rate, or the destination rate.

Each bill grants states the authority to require remote sellers to collect sales tax on transactions into their respective state if simplification steps are adopted. The varying simplification requirements include tax base, tax rate, and collection software requirements. We generally prefer the "hybrid" structure of the Marketplace Fairness Act, which will allow states to choose between a state-based solution like the SSUTA or a set of federally mandated minimum simplification steps before gaining collection authority on remote sales.

Conclusion

The National Retail Federation has long supported sales tax fairness legislation, and we are encouraged by the momentum that is building toward a solution. We look forward to working with the Committee on legislation to ensure effective and fair sales tax collection while relieving burdens placed on a growing sector of the economy.

April 25, 2012

An Open Letter to the Senate Committee on Finance: Avoid Encouraging Predatory State Tax Policies, Embrace Taxpayer Protection Legislation!

Dear Chairman Baucus, Ranking Member Hatch, and Members of the Committee:

The 362,000 members of National Taxpayers Union (NTU) commend you for holding a hearing today on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy." Throughout our 40-plus-year history, NTU and its members have actively engaged in the debate over fiscal federalism issues and their impact on the economy. As you explore this topic, we urge you to consider the benefits of several House and Senate bills that could protect taxpayers from unwise state and local tax policies – and, to beware of the serious drawbacks behind other pieces of legislation purporting to establish "tax fairness." Specifically, we commend your attention to the following proposals:

Oppose S. 1452, the Main Street Fairness Act, S. 1832, the Marketplace Fairness Act, and H.R. 3179, the Marketplace Equity Act. All of these bills contain the words "Fairness" or "Equity"; yet, by giving the federal government's blessing to state tax collection powers on "remote sales" beyond their borders, these pieces of legislation would achieve precisely the opposite outcomes that their titles express. Although supporters of the bills claim that they intend to level the playing field between "brick-and-mortar" retailers and online sellers, the result would be decidedly tilted. Traditional stores with physical outlets would not be forced to quiz their customers about place of residence and remit sales taxes to far-flung jurisdictions, but online and mail-order businesses would be saddled with such requirements. The tax compliance costs – especially to small sellers – would be considerable, and, as with income taxes, would not magically vanish with the existence of tracking software.

Furthermore, whether by compelling states' entry into the Streamlined Sales and Use Tax regime or by encouraging them to take similar steps voluntarily, this legislation would severely harm one of the most dynamic aspects of the federal system: tax policy competition. The reality is that brick-and-mortar as well as online sellers must contend with tax and regulatory regimes that fall in various ways upon their modes of commerce. Both can face profit and property taxes that are often punitive, especially for sole proprietorships or "Mom and Pop" establishments. "E-tailers," being heavily reliant on telecommunications and shipping infrastructure, bear a heavier tax load resulting from these necessary activities. Stores have greater sales tax collection and remittance obligations, but they have the business advantage of a physical location customers can visit. Both entities collect taxes on transactions where the buyer and seller are present in the same jurisdiction. We would contend that tax competition can make the commercial environment more hospitable for all sorts of business structures.

Finally, the concept of substantial physical presence, or nexus, has long provided a safeguard against many kinds of overaggressive state and local tax collection tactics. Throwing away this

established constitutional doctrine would have adverse consequences not only for sales tax collection standards, but for other types of taxes as well.

Rather than rushing to adopt legislation that wc . undermine key taxpayer protections, Members of Congress should give thought to other reforms that:

1) Preserve tax competition among states;
2) Protect businesses from onerous compliance burdens;
3) Recognize the federal role in facilitating fair and equitable interstate commerce; and
4) Limit the intrusiveness of governments at all levels in everyday economic activities.

One concept worth exploring is origin-based sourcing, which would treat all transactions – including remote ones – the same, by subjecting them to just one point of taxation (the jurisdiction within which the business is sited). Clearly, any approach designed along these lines would need to include assurances that any revenues resulting from its implementation would be used for across-the-board reductions in tax rates.

Support S. 543, the Wireless Tax Fairness Act. The four tenets of reform expressed above are applicable to many fiscal matters, none more appropriately than to telecommunications taxation. The typical combined federal, state, and local tax bite on a wireless bill is 16 percent, roughly twice as painful as the average bite on other goods and services. Just as it acted nearly 15 years ago to prevent multiple and discriminatory taxes on Internet access, Congress must now work to place limits on multiple and discriminatory layers of state and local taxation on wireless consumers. Such a move would also send the right message to providers, who would be better able to make innovative contributions toward a more robust economic recovery.

Support H.R. 1804, the State Video Tax Fairness Act. By failing to recognize the difference in business models between terrestrial television providers (who themselves are often overtaxed) and satellite providers, some state and local officials have sought to slap satellite customers with higher impositions on video service. Congress should counteract the impulse to impose higher burdens on one provider due to the excessive burdens faced by another. H.R. 1804 would prohibit inequitable net taxes that are dependent on the mode of programming delivery – a worthy idea that Senators should embrace with their own legislation as well.

Support S. 971, the Digital Goods and Services Tax Fairness Act. The dizzying rise of music downloads, mobile-phone apps, and other digital products has left some state and local tax officials giddy over the prospects of higher revenues. Given that consumers can now be charged taxes from several jurisdictions on the same purchase (e.g., from the state where the seller's server is located, from the state where the customer's phone bill is sent, from the location where the consumer downloads the item), it is perfectly legitimate for Congress to establish boundaries for these practices. S. 971 prudently prevents states from piling on repetitive download taxes, and requires an affirmative legislative act by a state (as opposed to an administrative edict) in order to tax digital goods. As NTU, Americans for Tax Reform, and other citizen groups stated in a letter delivered separately to you:

> Internet and digital commerce is a highly dynamic and rapidly growing sector of the American economy. The Digital Goods and Services Tax Fairness Act will help to eliminate any tax-related burdens on interstate commerce that could stifle the vital online market.

Support H.R. 1864, the Mobile Workforce State Income Tax Simplification Act. In today's economy, millions of Americans accept temporary assignments outside their state of residence or traditional workplace location. Yet, some state and local tax laws are horrendously out of touch with this fact, causing unnecessary compliance headaches for workers and employers alike. H.R. 1864 would set federal guidelines for the way states and localities can impose earnings taxes on most nonresidents, including a minimum threshold of time spent in-state (more than 30 days) before compliance requirements are triggered. All other tax obligations in the worker's or employer's home state would remain unchanged. NTU urges Members of the Committee to consider authoring a Senate companion to H.R. 1864.

Other legislation introduced in this Congress could simplify and clarify state and local tax policy to improve America's competitiveness. This would include the Business Activity Tax Simplification Act (H.R. 1439) and S. Res. 309, which affirms that Congress will not give states "the authority to impose any new burdensome or unfair tax collecting requirements on small online businesses."

As Members of the Committee review these and other legislative proposals, NTU would remind you of the fundamental contradictions between bills that would act to expand state tax collection powers in new and destructive directions versus those that establish sensible curbs on such powers. In our view, all Members of Congress who consider themselves taxpayer advocates should recognize these differences and vote accordingly. It is inconsistent to work toward enactment of legislation such as S. 1452 and S. 1832, which directly clashes with the salutary precepts behind legislation such as S. 971 and H.R. 1864. As you and your colleagues consider next steps, NTU and its members look forward to charting with you a legislative course that avoids obstacles to prosperity and leads to a brighter economic future. Toward this end, we hope you will find our recommendations helpful.

Sincerely,

Pete Sepp
Executive Vice President

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House of Representatives
State of Idaho

Thursday, April 26, 2012

Comments for inclusion in the hearing record for:
Tax Reform: What It Means for State and Local Tax and Fiscal Policy
Held before the United States Senate Committee on Finance
Wednesday, April 25, 2012, 10:00 AM

Submitted by:
Representative Jeff Nesset
1517 Paddock Avenue
Lewiston, ID 83501

Representative Leon Smith
1381 Galena Drive
Twin Falls, ID 83301

Unites States Senate Finance Committee, Chairman Baucus, Ranking Member Hatch, Idaho Senior Senator, Mike Crapo and Members of the Senate Finance Committee:

Idaho State Legislators have been working on an e-fairness commerce bill for several years. Many of us, along with Idaho Governor Otter, realize how vital this is to the Idaho economy. After a summers work, a 79 page e-fairness state bill that would put Idaho in conformance with the Streamlined Sales Tax Agreement was introduced but defeated by a close vote in the House Revenue and Taxation Committee.

So we come to you for help.

Idaho needs to facilitate collection of sales tax from remote online-sales. We believe that Idaho alone is losing out on approximately $35 million per year of uncollected revenue from the sales tax online-sales should bring in. To say that again, it is roughly 35 million dollars of sales tax that our state is missing out on; $35 million that we could use to possibly lower the overall tax burden on Idaho citizens.

But what is really unfair is that the hard working citizens of our state, who build shops and invest in main street stores, all have to pay our Idaho state sales tax. Yet, their ever-present, ever-growing, main competitors, the online-retailers, do not have to pay a penny in sales tax to Idaho. Why not? Well, it is because of Supreme Court decisions *(Quill Corp vs. North Dakota and Bellas Hess vs. Illinois)* that inadvertently created a tax loophole for the online retailers. The problem is that this tax loophole still exists and Congress, seems to be the only entity that can lift this for all states collecting sales tax.

Idaho really is a strong Free Enterprise state and we are quite proud of that. But we find ourselves stuck with a set of unfair rules that our shop owners in Idaho have to live by. So, you can see why we need you as a Legislative body to free up this shackle of business favoritism towards online sellers, which impairs our competitive edge and creates an unlevel playing field. Senators, we are asking that you "grant"states the right to collect online-retail sales tax.

We encourage the US Congress to successfully pass the Marketplace Fairness Bill because Idaho is ready with a 79 page bill that we could pass and be ready for the Federal Act.

We, Representative Jeff Nesset, State House Seat 7A and Representative Leon Smith, State House Seat 24A, thank you for your time and encourage the Senate body to support the Marketplace Fairness Act, giving states' rights back to the individual states.

Representative Jeff Nesset
1517 Paddock Avenue
Lewiston, ID 83501

Representative Leon Smith
1381 Galena Drive
Twin Falls, ID 83301

Statement of

Steve DelBianco

Executive Director

NetChoice

Testimony before the

United States Senate Committee on Finance

Tax Reform: What It Means for State and Local Tax and Fiscal Policy

April 25, 2012

Chairman Baucus, Ranking Member Hatch, and members of the committee: thank you for holding this hearing on federal tax reform and its impact on state and local governments. My name is Steve DelBianco, and I serve as Executive Director of NetChoice, a coalition of leading e-commerce and online companies promoting the value, convenience, and choice of Internet business models. NetChoice members include industry leaders such as eBay, Expedia, Facebook, LivingSocial, NewsCorp, VeriSign, and Yahoo, plus several thousand small online businesses.

In this testimony we are addressing just the portion of this hearing that examines the impact of current Senate legislation that would authorize states to impose sales tax obligations on out-of-state businesses (S.1832 and S.1452).

Why don't online retailers pay sales tax to every state?

Last November, the editors of the Wall Street Journal asked NetChoice whether all online retailers should have to pay sales tax to every state. My published essay began with this:

> *Should online retailers have to collect sales tax? Yes, and they already do.*
>
> Just like all retailers, online stores must collect sales tax for every state where they have a physical presence. That's why Amazon.com adds sales tax to orders from customers in the 5 states where it has facilities. But Amazon and online retailers aren't required to collect tax for other states, leaving those customers to pay a "use tax" that states rarely enforce against individual taxpayers. This framework frustrates state tax collectors and businesses that compete with online retailers. But when we learn how this physical presence requirement evolved, it becomes clear why we should retain this standard for imposing new tax collection burdens on online retailers.[1]

As members of this committee know, today's physical presence standard is based on Article One of the United States Constitution, created 225 years ago to stop states from impeding interstate commerce. The so-called Commerce Clause was a necessary condition to unite the independent colonies, since they had a legacy of imposing customs duties and trade barriers to favor in-state businesses over out-of-state competitors.

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[1] Steve DelBianco, *Should States Require Online Retailers To Collect Sales Tax?*, Wall Street Journal (Nov. 14, 2011) (emphasis added).

Fast-forward to the 1960s, when state tax collectors wanted catalog retailers to collect their sales taxes, even where those catalogs had no operations in the state. The US Supreme Court relied on the Commerce Clause in deciding that states could not impose tax collection requirements on catalogs "whose only connection with customers in the State is by common carrier or the United States mail."[2]

In 1992, the Supreme Court took another look at tax collection by an office products catalog company by the name of Quill. Seeing a patchwork of rates and rules for several thousand sales tax jurisdictions, the Court again held that requiring out-of-state companies to collect and remit taxes was so complicated that it presented an unreasonable burden on interstate commerce.

Moreover, the Supreme Court was not moved by the state's argument that computer technology created the necessary simplification. Instead, the Supreme Court acknowledged the lower court's finding that advances in computer technology had eased the burdens of tax collection, but still found the requirement of tax collection unduly burdensome.[3]

And *Quill* was not about "fairness." While some argued fairness as justification for the collection requirement, "[i]n contrast, the Commerce Clause and its nexus requirement are informed *not so much by concerns about fairness* for the individual [state] as by *structural concerns about the effects of state regulation on the national economy*."[4]

Quill is the law of the land today, protecting American businesses from sales tax imposition by states where that business has no physical presence. *Quill* also made it clear that states could simplify their sales tax systems and come back to the Supreme Court and show that they have truly eliminated the unreasonable burden on interstate commerce.

But instead, a handful of states chose to skip the harsh judgment of the Court and go directly to Congress to request the power to impose these burdens on out-of-state businesses. Their efforts began a decade ago with the Streamlined Sales Tax Project (SSTP).

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[2] *Nat'l Bellas Hess, Inc.* v. *Dept. of Rev. of Ill.*, 386 U. S. 753 at 758 (1967).

[3] *See Quill Corp. v. North Dakota*, 504 U.S. 298 at 313 FN 6 (1992).

[4] *Id.* at 312 (emphasis added).

Despite a decade of effort, the actual simplification achieved by the SSTP is not nearly sufficient to justify having Congress abandon its role in protecting interstate commerce. Rather, the SSTP has shown that *simplification has become just a slogan – not a standard.*

Most critics cite the fact that SSTP originally promised just one tax rate per state, but now accommodates over 9,600 local jurisdictions,[5] each with its own tax rate and sales tax holidays. Moreover, consider these examples of how the simplification campaign has come unraveled:

> *SSTP abandoned a destination-sourcing scheme to accommodate both origin and destination based taxes at the same time.*
>
> One foundational principle of simplification was to use the delivery destination of any shipment to determine which state's rates and rules should apply. But that was deemed too troublesome for states that base their sales tax on where shipments *originate*, not where they are delivered. To help those origin-based states join the SSTP, the Governing Board now lets states use origin-based rules for intrastate shipments while requiring out-of-state sellers to collect sales tax based on the destination jurisdiction.
>
> *States are systematically undermining their promise to simplify definitions and rules.*
>
> Member states have already strayed from the library of definitions in their Agreement and have allowed states to retain non-conforming definitions by calling them something other than a sales tax. Moreover, states now want to allow tax thresholds on individual sale transactions, which was one of the major complexities that SSTP was designed to eliminate.

Despite these concessions, less than half of eligible states have joined SSTP (only 21 full member states in SSTP out of 46 states that have sales and use tax).

Why was SSTP losing momentum among states that were told they would receive billions of dollars in new tax revenue? Possibly because non-member states are reluctant to let unelected tax administrators make decisions about tax rules and determine compliance. More likely, SSTP was losing momentum because states began to see the revenue estimates as wildly

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[5] *See* Scott Drenkard, *State & Local Sales Taxes in 2012*, Tax Foundation Fiscal Fact No. 291, Feb. 14, 2012, at http://www.taxfoundation.org/news/show/27967.html.

inflated. According to a study by economists Robert Litan and Jeffrey Eisenach, uncollected sales tax on e-commerce in 2012 is about $3 billion nationwide, which is only 1/3 of one percent of total state and local tax revenue.[6]

Recently, despite flagging momentum and diminishing revenue estimates, members of this committee have surely noticed increased lobbying efforts to overturn *Quill's* physical presence test and authorize states to collect from remote retailers. Aside from the usual tax proponents in state government, the renewed push is coming from big-box retailers.

Big-box retail chains are pushing hard for federal legislation for a simple and predictable reason: it serves *their* interests. Even a little simplification helps a big-box retailer who must already collect tax for most states. Big-box retailers now have expansive web-stores of their own and give customers the convenience of doing pickups and returns at their local stores. These chains use plenty of local public services wherever they have stores, so they must collect sales tax in all their states – as required under current law. The Eisenach study described above looked at sales collection practices for the top 500 e-retailers, and found that 17 of the top 20 already collect in at least 38 states.

Top 20 e-Retailers with their Collection and Remittance of Taxes

Company	States
Amazon.com	5
Staples	44
Dell	46
Office Depot	46
Apple	46
OfficeMax	46
Sears	46
CDW	46
Newegg	3
Best Buy	46
QVC	46
SonyStyle.com	46
Walmart.com	46
Costco Wholesale	38
J.C. Penney	46
HP Office	46
Circuit City Stores	29
Victoria's Secret	45
Target	46
Systemax	5

Another way that overturning *Quill* would also help big-box retailers is that it would force tax collection costs on their biggest online competitor, Amazon. Big-box retailers have aggressively gone after Amazon in the states, lobbying for new "Amazon Tax" laws declaring that Amazon already has physical presence by virtue of its advertising affiliates, distribution centers, or other

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[6] Eisenach & Litan, *Uncollected Sales Taxes On Electronic Commerce: A Reality Check*, Empiris LLC (Feb. 2010), *available at* http://bit.ly/EisenStudy.

subsidiaries in the state. The big-box retailers also lobbied for a new tax reporting law in Colorado, which was recently overturned by federal court as a violation of the Commerce Clause.[7]

Despite the setback in Colorado and pending court challenges of the "Amazon Tax" in New York and Illinois, this aggressive and expensive state lobbying campaign has succeeded in creating well-publicized tax compliance problems for Amazon. Those problems have helped to drive Amazon to support federal legislation such as S.1832 and S.1452.

But there's another reason for Amazon's about-face: the company is changing its business model by adding distribution centers in new states, placing drop-boxes in convenience stores, and offering coupons for local merchants. As a result, Amazon will have physical presence in eleven states by 2014[8] – requiring Amazon to collect sales tax for more than a third of all Americans. Like the big-box stores, Amazon will soon see a benefit to overturning *Quill* in return for a bit of simplification and for burdening its smaller online-only competitors with new tax collection costs.

To impose expensive collection burdens on small sellers would be grossly unfair, which brings us to the aspect of "fairness" in the debate over new Internet sales taxes.

Is this debate really about "fairness"?

The Constitution's Commerce clause has nothing to do with fairness. As explained above, it was all about preventing unreasonable barriers to interstate commerce, such as the customs duties imposed by the independent states before they united. In fact, *Quill* explicitly dismissed the fairness argument, saying the "Commerce Clause and its nexus requirement are informed not so much by concerns about fairness" but rather "the effects of state regulation on the national economy."[9]

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[7] *See* Order of Ct., *The Direct Marketing Ass'n v. Huber* (U.S. Dist. Ct. Colo. Mar. 30, 2012), *and see* 1 Colo. Code Regs. § 201-1:39-21-112.3.5 (2010).

[8] By 2014 Amazon will collect and remit sales taxes in the following states California, Indiana, Kansas, Kentucky, North Dakota, New York, Pennsylvania, South Carolina, Tennessee, Virginia, and Vermont.

[9] *Quill*, 504 U.S. at 312.

"Fairness" is what you get *when everyone plays by the same rules.* And today, with *Quill* in place, all online and offline businesses play by exactly the same rule: all retailers collect sales tax for every state where they choose to have a physical presence.

Ironically, in many states the fairness argument cuts the other way. A retail store on main street collects sales tax for just the one jurisdiction where it's located. But an online retailer operating right upstairs must collect and remit for each of the local towns and counties whenever it ships within the state. In some states that means collecting for several hundred local tax jurisdictions, each with its own rates and rules. Yet when customers from surrounding towns walk in the door, the store collects and files only in the local jurisdiction.

Again, all retailers collect sales tax for every state where they choose to have a physical presence. I say, "choose" because it is the business that chooses whether to be just an online retailer or to operate physically in multiple states. When a business chooses to open stores or put sales reps in another state, it accepts the obligation to collect that state's sales tax.

There's actually little evidence that retailers who *do* collect sales tax are losing significant sales to online retailers who aren't required to collect sales tax. That makes sense, since sales tax and shipping costs aren't added until a consumer's online shopping cart goes to checkout. So comparison shoppers are usually comparing prices *before* adding any tax and shipping charges. Moreover, online shoppers usually pay shipping and handling charges that offset any tax that's not collected on most commodities. Small and expensive electronics are a notable exception; however, SSTP proponents have shown us no studies indicating that significant numbers of electronics shoppers deliberately choose out-of-state online retailers just so they can avoid paying sales tax.

e-Commerce is the best hope for Main Street to compete with Big-Box Stores

Those who make the fairness claim about online versus offline are missing the far greater fairness concern of small retailers competing against big-box chain stores.

For decades, "main street" retailers have been getting battered by Walmart and other national chains. To survive, many main street retailers have gone online with their own web stores or with e-commerce platforms to serve repeat customers and to find new customers across the country. For example, the specialty retailer SilverGallery.com has a warehouse and store—located on Main Street—in Waynesboro, Virginia. SilverGallery, which was featured in a Wall

Street Journal article last year, does some walk-in trade, but most sales come from their web store and other online channels.[10] Online sales growth enabled SilverGallery to buy their building and increase employment, right there on Main Street.

The last decade has seen another body blow delivered by big-box chains, who integrated their website operation with their stores in every city and town. Customers love the savings of doing in-store pickups to avoid shipping charges. And they love the convenience of returning online purchases to stores for exchange or credit – instead of packaging returns and standing in line at the post office. But small sellers like SilverGallery can't afford to open stores in every state. It's yet another advantage that big retailers have over small businesses with websites. The big chains also negotiate much lower rates for advertising, shipping costs, and health insurance, too.

Next comes the knockout punch for small retailers. Overturning *Quill* may be good news for big-box retailers with websites, since they already have to collect in nearly all states. But overturning *Quill* will definitely raise costs and prices for small businesses that compete – and survive – via their web and catalog sales.

What is the impact on small businesses if they are required to pay sales tax to 46 states?

What costs would a small business face if Congress forced them to pay sales tax to all 46 states? The SST Cost of Collection[11] study found that a small business (under $1M in annual sales) spends 17 cents for every tax dollar it collects for states. And even if SST software works as promised, that only helps with 2 cents of the 17 cents in costs per dollar collected. That leaves small businesses with a 15% cost burden on every dollar they collect, for things such as:

- Paying computer consultants to integrate SST software into home-grown or customized software;
- Training customer support and back-office staff;
- Answering customer questions about the taxability of items, or sales tax holidays in remote jurisdictions;
- Handling audit questions from 46 states; and
- Paying accountants and computer consultants to answer all these questions.

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[10] *See* Angus Liten, *Sales-Tax Measures 'to Cost Us Big',* Wall. St. Jo. (Dec. 1, 2011).

[11] *Available at* http://www.netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf.

These collection burdens will be a big problem for small catalog and online businesses that collect only their home-state sales tax today. Ask any small business, on Main Street or online, and you'll learn it's hard enough to collect sales tax for one state, let alone all 45 states with sales tax laws of their own.

With a full picture of what small online businesses would face from SST, it's easy to see why Senator Wyden and five co-sponsors introduced Resolution 309 to protect our nation's Internet entrepreneurs. S. Res 309 is titled "Supporting the Preservation of Internet Entrepreneurs and Small Businesses." Its main point is this simple pledge:

> Congress should not enact any legislation that would grant State governments the authority to impose *any new burdensome or unfair tax collecting requirements on small online businesses* and entrepreneurs, which would ultimately hurt the economy and consumers in the United States.[12]

The bottom line on "fairness" is that big-box retailers have wielded that term for their own benefit to the detriment of any small retailers they haven't already extinguished.

Is it a new tax? Yes.

State sales tax laws put obligations on both buyers and sellers in order to maximize revenue collection. States levy a sales tax on sellers within their jurisdiction, and it's up to the seller whether to pass that tax along to buyers. Most sellers do pass the tax along to buyers, whether at the cash register, online, or over the phone. But after an audit, a seller is liable for any sales tax they were obliged to collect but failed to do so, even when the seller can't recover the tax from those previous customers. This demonstrates how sales tax is due from *sellers* whose activities or locations create enough of a physical presence for a state to impose collection obligations.

If Congress overturns the *Quill* physical presence standard, retail businesses would be forced to pay a new tax to states where they have no physical presence. Most of those businesses would pass the tax along to their customers, but, make no mistake about it, the states will demand that businesses pay the new tax — whether or not their customers were charged.

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[12] S. Res. 309, 112th Cong. (2011) (emphasis added).

Congress can take the time to require real simplification

In truth, the actual simplification required in S.1452 and S.1832 is not nearly sufficient to convince Congress that it should abandon its Constitutional role in protecting interstate commerce.

Fortunately, Congress can afford to take the time to design legislation that requires real simplification and makes states accountable to these requirements. As noted above, the uncollected taxes are far lower than tax advocates have claimed: uncollected sales tax on consumer e-commerce is only 1/3 of one percent of all state and local taxes, as explained above. And the uncollected amounts are not growing as fast as tax advocates have claimed, since the fastest growth in e-commerce is among multi-channel retailers who already collect for all states where they have stores. In fact, 17 of the top 20 e-retailers already collect for at least 38 of the 46 sales tax states.[13]

However, if Congress is determined to overturn Constitutional protections for interstate commerce, it must exempt small businesses, require states to adopt minimum simplification requirements, and create fair procedures to resolve sales tax disputes between states and taxpayers.

Below are minimum simplifications that should be part of any federal legislation that overturns the *Quill* standard of physical presence for states to impose sales tax on remote businesses.

Minimum Simplification Requirements

- A robust exception for small sellers. Bills currently in Congress include small seller thresholds that are simply too low to be considered realistic. Previous Congresses pegged the small seller exception at $5 million in annual remote sales, a figure that should be the bare minimum in any federal legislation. In fact, the small seller threshold should be higher than $5 million, given that states are continuing to add new tax jurisdictions at the rate of 400 per year.
- There should be a single sales tax rate for remote sales made into each state, as was the original goal of the SSTP. State lawmakers would, of course, be able to allocate sales tax proceeds among local jurisdictions.
- States should compensate businesses for the reasonable cost of collecting sales taxes. This too was part of earlier federal legislation.
- A single set of definitions for taxable and exempt products for <u>all</u> states.

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[13] Eisenach & Litan, *Uncollected Sales Taxes On Electronic Commerce: A Reality Check*, Empiris LLC (Feb. 2010), *available at* http://bit.ly/EisenStudy.

- A single audit conducted by retailer's home state on behalf of all states.
- All states should accept a single sales tax return filed with a business' home state. The home state revenue department would be responsible for distributing funds to remote states.
- A single national rule for sourcing sales. The SSTP originally maintained destination sourcing for all sales tax transactions. But to accommodate origin-based states, SSTP's Governing Board voted to allow origin sourcing for in-state sales while requiring destination sourcing for remote sales. Such "dual sourcing" should not be permitted in federal legislation.
- Eliminate sales tax holidays or adopt a single uniform national sales tax holiday with uniform date and product exemptions.
- States must provide certified software for collection, filing, and remittance. Users of the software would be immune from civil liability for errors in taxes collected.
- Exclude businesses based in states that have no sales tax of their own (New Hampshire, Delaware, Montana, Oregon, and Alaska)

Furthermore, if Congress grants states the authority to impose sales tax on remote sellers, there is a critical need for mechanisms to hold states accountable to the minimum simplification requirements above. Under the Tax Injunction Act (28 USC§1341), taxpayers are forced to use state courts to litigate disputes with state tax collection authorities, even on questions of whether a state is following federal law. Out-of-state businesses should be able to challenge state tax assessments that violate federal statutes or the U.S. Constitution in federal court – not in state courts.

Conclusion: Congress could consider a multi-state compact – Not a national mandate.

Finally, Congress must maintain some form of market discipline to stop states from expanding the complexity of their sales tax systems and skirting the minimum simplification requirements. Fortunately, Congress has a simple way to enforce "tax competition" as part of any legislation that overturns the physical presence standard: Congress could authorize remote collections through a multi-state compact instead of a national mandate on *all* businesses.

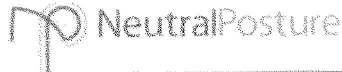
Tax advocates seldom acknowledge that S.1452 and S.1832 would impose collection burdens on businesses in *all 50 states* – including those in states that don't join SSTP and those in states that don't even have a sales tax. To the contrary, pro-tax advocates reassure legislators that they would retain their state sovereignty, telling them, "you don't have to join SSTP" and "you can drop out any time you want."

But if Congress overturned *Quill's* physical presence standard, lawmakers in all 50 states would lose the sovereign right to protect their citizens and businesses from tax burdens imposed by other states.

If these new collection burdens are hurting businesses in a state, their legislators won't be able to rescue those businesses if Congress makes collection mandatory for all.

This comes as a surprise to many lawmakers who are just getting their arms around the SSTP and its accompanying Congressional mandate. And it will come as a complete shock to businesses all around the country if they have to start collecting for over 9,600 tax jurisdictions.

Contrast the national mandate with a multi-state compact. An optional compact would allow states to opt-in to the collection compact if they believed the new tax revenue justified the burdens on in-state business who would have to collect for remote states in the compact. By the same token, states could opt-out of the compact to protect their state businesses if remote state tax burdens become excessive. States that opt-out would forego their authority to force remote sellers to collect their own state's sales tax, but at least states would preserve their Constitutional right to protect their businesses from unreasonable burdens on interstate commerce.



April 17, 2012

Senate Committee on Finance

Attn. Editorial and Document Section

Rm. SD-219

Dirksen Senate Office Bldg.

Washington, DC 20510-6200

Re: Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Dear Chairman Baucus, Ranking Member Hatch and Members of the Committee:

I am Rebecca Boenigk, CEO and Chairman of Neutral Posture. Thank you for the opportunity to submit this written testimony in support of a federal legislative solution to the business activity tax nexus issue, as is set forth in H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA"). I respectfully urge quick enactment of this important piece of legislation.

I founded Neutral Posture in 1989 with my mother, Jaye Congleton. Our company manufactures ergonomic seating products and accessories for the office, lab and manufacturing areas. Neutral Posture is the only woman-owned seating manufacturer in the United States and is a certified women's business enterprise (WBE). The company is one of the top diversity suppliers for the United States government and Fortune 500 companies worldwide. Currently, we employ 75 people in Texas and five in Canada.

Although Neutral Posture is physically present only in Bryan, Texas and Chicago, Illinois, we have been assessed income-based taxes by California, Florida, Georgia, Indiana, Minnesota, Ohio, Pennsylvania and Washington, based on sales we have made to customers located in those states. While we do make use of the services of independent sales representatives in every state in which we have customers, those individuals are not employees of Neutral Posture, and they service many companies besides ours.

Of course, our sales representatives located in other states do pay income taxes on their own business profits in their own states, just as we pay income taxes in Texas and Illinois. We do not object to paying taxes in states where we have a presence and receive government services. We do object to paying business activity taxes to states where we have no physical presence.

It is impossible to run a business not knowing what jurisdiction next will send us an assessment for income-based taxes. Nor does a smaller business, like ours, have the means to fight such unfair assessments through costly and protracted litigation. When forced to pay business activity taxes to a state where we have no physical presence, we are forced to make a choice between passing such costs on to our customers and taking a hit to our bottom line.

BATSA codifies the traditional physical presence nexus standard, meaning that a state or locality cannot impose a business activity tax on a business unless that business has a physical presence (such as employees, an office or real property) in the state for more than fourteen days in a taxable year. The bill establishes a bright-line standard that will eliminate confusion for both state tax administrators and businesses, resulting in less litigation, fewer nexus audits, less tax compliance guesswork and, thus, greater investment in business growth and jobs. Enactment of the bill is crucial to our company.

Thank you again for your attention to this very important issue.

Sincerely,

Rebecca Boenigk
CEO & Chairman
Neutral Posture

NEW JERSEY BANKERS ASSOCIATION
With New Jersey Banks, New Jersey Prospers

411 North Avenue East • Cranford • New Jersey • 07016-2436 • 908-272-8500 • Fax 908-272-6626

Statement of the New Jersey Bankers Association

Submitted to the United States Senate Committee on Finance

April 25, 2012

Hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

The New Jersey Bankers Association ("NJBankers") appreciates the opportunity to submit this statement for the record of the Senate Finance Committee hearing on Tax Reform: What it Means for State and Local Tax and Fiscal Policy. NJBankers strongly urges the Committee to support a federal legislative solution to the business activity tax nexus issue, as set forth in H.R. 1439, the Business Activity Tax Simplification Act ("BATSA"). That bill would clarify and modernize the rules governing a state's ability to impose income-based and similar taxes on non-resident companies that have no physical presence in the taxing state.

NJBankers represents 118 financial institutions in New Jersey. Our members employ thousands of New Jersey residents and contribute greatly to the New Jersey economy.

Many states and localities are attempting to impose business activity taxes on businesses that merely have customers in the taxing jurisdiction, but which do not receive any significant benefits or protections (such as fire protection, police protection, sewers, *etc.*) from the jurisdiction. In the financial services industry, such attempts have focused on taxing non-resident banks that (a) issue credit cards to consumers who reside in the taxing state, (b) receive interest income from loans secured by tangible personal or real property located in the taxing state, or (c) take title to commodities when engaged in trading. Such aggressive "economic nexus" approach violates the Constitution's Commerce Clause, has a chilling effect on the economy and produces incredible compliance burdens for businesses operating in interstate commerce. Furthermore, the practice amounts to a clear burden on interstate commerce and falls squarely within the jurisdiction of Congress to correct.

BATSA would codify the traditional physical presence nexus standard, meaning that a state or locality cannot impose a business activity tax on a business unless that business has a physical presence (such as employees, an office or real property) in the state for more than fourteen days in a taxable year. BATSA applies to all direct taxes (business activity taxes). This includes taxes such as an income tax, a gross

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Second Vice Chairman
Senior Vice President
Roma Bank
Robbinsville, NJ

John E. McWeeney, Jr.
President/CEO
New Jersey Bankers Association
Cranford, NJ

receipts tax, a gross profits tax, single business taxes, franchise taxes, capital stock taxes, and business and occupation taxes. It does not apply to transaction taxes based on gross receipts, such as sales and use taxes, or gross premium charges on insurance companies. Thus, under BATSA, states and localities would be allowed to impose business activity taxes on businesses within their jurisdiction that have employees in the state, or property that is either leased or owned in the state, for more than a *de minimis* number of days in a year. The bill protects businesses from business activity taxation if the company merely solicits sales in the state or enters the state just to purchase goods or property.

BATSA would not allow businesses that operate in interstate commerce to unlawfully avoid state taxes. All businesses would continue to pay tax to states in which they have a physical presence. In addition, the bill explicitly ensures that the states retain all tools they currently (and successfully) use to combat tax avoidance.

The physical presence standard set forth in BATSA is the most appropriate standard for business activity taxation because it is a fair, bright-line standard that may be predictably understood and applied and because it reflects how income is earned. NJBankers urges Congress to enact this important legislation now.

Michael Affuso
Senior Vice President and Director of Government Relations

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Michael P. Smith
President and CEO

April 30, 2012

Committee on Finance
United States Senate
Attn: Editorial and Document Section
Room SD-219
Dirksen Senate Office Building
Washington, DC 20510-6200

RE: Tax Reform: What it Means for State and Local Tax and Fiscal Policy

To the Committee:

The Business Activity Tax Simplification Act is designed to address the current imbalance between the needs of states for additional revenue and the needs of businesses for clarity in the state taxes to which they are subject by restricting state taxation to businesses with a physical presence in the taxing jurisdiction. It is important to note that the bill will not create a system in which business profits escape state taxation. States in which a business maintain their headquarters, production or distribution facilities, and service locations will continue to tax the full profits of those businesses wherever earned. This bill will simply prevent other states in which businesses have chosen not to locate any operations from siphoning off those tax dollars.

Attached is a statement on the bill that the New York Bankers Association would like considered as part of the record of the Finance Committee's hearing on Tax Reform: What it Means for State and Local Tax and Fiscal Policy. We appreciate the Committee's consideration of this statement.

Sincerely,

Michael P. Smith

cc: The Honorable Charles E. Schumer

Attachment

New York Bankers Association
99 Park Avenue, 4th Floor
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(212) 297-1600/www.nyba.com

STATEMENT OF THE NEW YORK BANKERS ASSOCIATION

BEFORE THE SENATE COMMITTEE ON FINANCE

ON TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL

TAX AND FISCAL POLICY

April 25, 2012

The New York Bankers Association appreciates the opportunity to submit this statement for the record of the hearing of the Finance Committee's review of the meaning of tax reform for state and local tax and fiscal policy. We would like to draw the Committee's attention to the Business Activity Tax Simplification Act, a House-introduced version of which is attached. The New York Bankers Association strongly supports legislation that would clarify and modernize the rules governing a state's ability to impose income taxes on companies that have no physical presence in the state. Our Association is comprised of the community, regional and money center commercial banks and savings institutions doing business in the State of New York. Our members hold aggregate assets in excess of $10 trillion and employ more than 200,000 New Yorkers.

This legislation will clarify that states may not tax out-of-state intangible property or services. Current law clearly precludes state taxation of out-of-state tangible personal property and real estate. The bill will also require that an entity have a physical presence in a state in order to subject the entity to the state's taxing jurisdiction. The bill sets forth criteria for determining whether a physical presence exists.

This legislation will clarify situations in which a state can constitutionally tax out-of-state corporations. It is particularly important for a State like New York that sells vast amounts of financial services in other states. The physical presence standard contained in the bill is one that the United States Supreme Court has recognized as an appropriate nexus for state taxation.

In recent years, an increasing number of states have enacted legislation taxing business activities that occur outside their physical jurisdiction and that bear only a remote relationship to the taxing states. In the financial services arena, these enactments have largely focused on taxing loan and investment relationships entered into by residents of the taxing states with non-resident business entities whose only relationship with the taxing state is the use of instruments of interstate commerce, such as the Internet, the United States Postal Service and the telephone to transact business with their customers.

These states have been characterized as "market states," because they attempt to tax the market for goods and services, rather than the physical entity that provides the goods or services.

This system of taxation is clearly a burden on interstate commerce and falls squarely within the jurisdiction of Congress to address. The home states of companies being taxed by market states already tax the profits of these companies, resulting either in double taxation or in a reduction in revenue for home states. With the increased reliance by customers on the Internet, the taxation of out-of-state residents and businesses will clearly become a more and more attractive means to enhance a state's revenue. It can therefore be expected that, without Congressional oversight, attempts to tax companies without a physical presence in a state will continue to increase.

The Business Activity Tax Simplification Act draws a clear distinction between allowable and impermissible taxation by a state of the intangible activities of out-of-state residents and businesses. We strongly urge that the legislation be enacted.

Statement of David Rolston, President and CEO of Hatco Corporation on behalf of the North American Association of Food Equipment Manufacturers 161 North Clark Street, Suite 2020, Chicago, IL 60601

Submitted to the Senate Finance Committee hearing April 25, 2012 on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

The North American Association of Food Equipment Manufacturers, representing more than 600 US companies that manufacture commercial food preparation, cooking, storage and table service equipment used in restaurants, cafeterias, and other food service establishments, strongly urges the Senate Finance Committee to consider the impact of state-specific "business activity taxes" on commerce.

Several states are now asserting "business activity taxes" on sales of firms that have no physical presence or other "nexus" in their states. These practices are inconsistent among states, discriminatory in application, and disruptive to commerce across state lines. They interfere with intelligent business planning and therefore to the economic growth and economic health of firms that do business across state lines. The House Judiciary Committee has recently reported out, with strong bipartisan support, legislation --HR 1439, The Business Activity Tax Simplification Act-- that would correct this situation before further harm is done. We urge the Senate to consider similar legislation.

Allow me to elaborate from the experience of my own firm. I am David Rolston, President and CEO of Hatco Corporation., a manufacturer of commercial food warming equipment, toasters, and water heaters headquartered in Milwaukee, Wisconsin. We have 375 employees, and the company is 100 percent employee-owned.

I also am chair of the Government Relations Committee of the North American Association of Food Equipment Manufacturers,

This is a surprisingly large industry. Total domestic sales are over $8 billion -- and it is an industry composed predominantly of small businesses. Sixty-six percent of the members have sales less than $10 million a year with fewer than 100 employees. We have members from 46 states of the union. Typical products are freezers, refrigerators, stoves, ovens and broilers, food warmers, display tables, serving trays, cutlery-- virtually everything you would see in a commercial restaurant kitchen or food service area. Most, like Hatco, are single-state companies, and have no physical presence outside their home states.

Efficiency and predictability are essential to a small business. The practice of some states to assess "business activity" taxes on firms that have no physical presence in the taxing jurisdiction

is a significant administrative cost, adding an unnecessary layer of inefficiency, and limiting our ability to grow.

Hatco, like most NAFEM members, sells through independent manufacturers' representatives who represent 10-15 companies. We also use independent service agents to complete warranty repairs on our equipment. Again, these are independent companies that service the equipment of many different manufacturers. We have no employees or other physical presence outside of Wisconsin. Nonetheless, we are now being forced to pay business activity taxes in four states where we have customers but no physical presence. Justification given by the states for these taxes is the existence of the representatives or service agents.

Of course, our manufacturers' representatives and service agents in these states do pay income taxes on their own business profits in their own states, just as we pay income taxes in Wisconsin. That is as it should be. We should be paying taxes in states where we have presence and receive government services. For us, that is Wisconsin. We should not be paying business activity taxes – which are a form of income tax – where we have no physical presence. (These are not, of course, sales taxes – a clarification I am sure is not needed in this committee; these business activity taxes are quite different from and on top of sales taxes.)

We don't know what other states will come at us next. These tax bills catch us by surprise. When states first contact us, they sometimes come on hard. One state originally demanded that we pay eight years of back taxes. This would have been significant. Others have threatened penalties. Litigation, of course, is impractical for a small firm. We try to negotiate but often end up making an economic decision. We can't pass the costs on, so both the tax payments and, even worse, the administrative costs, are off our bottom line.

One example: we were subjected to an audit by the State of Washington Department of Revenue, one of the 4 states in which we already pay a Business Activity Tax. They audited the excise tax returns filed by Hatco for the period 1/1/06 to 6/30/09 related to business and occupation (B&O) tax.

The B&O tax in the state of Washington is a business "privilege" tax assessed on the value of shipments made by Hatco into the State of Washington. Hatco has no physical presence in the state of Washington but is still required to periodically report and pay the B&O tax..

The state of Washington originally notified Hatco in 2005 that we owed the B&O tax. This resulted in Washington's initial audit of Hatco and a very lengthy and costly audit and appeal process in 2005 and 2006. That audit covered the period 1/1/98 - 9/30/05. Hatco begrudgingly settled the audit on 7/26/06 after much cost and time was spent contesting the B&O taxation.

The auditor in charge of the recent audit initially was not even aware of the prior audit; yet after Hatco informed her of the prior audit and she located the files in the State of Washington's archives, she nonetheless contended that she needed to perform an audit for the period 1/1/06 - 6/30/09.

Please be aware that our quarterly B&O taxes are approximately $1,000...there is simply not much at stake here.

Nonetheless we had to go thru the audit. The audit included an introductory on-site meeting on 8/25/09, numerous email and telephone exchanges, preparation of data files and copies of various documents as requested by the Washington auditor, and consultation with our CPA tax advisors.

Ultimately Hatco received a letter dated 12/1/2009 from the State of Washington Department of Revenue indicating "no tax adjustments were made since no errors were found...".

Hatco's accounting and information services personnel incurred approximately 40 hours of time in order to comply with the various requests from the Washington state auditor. Hatco also incurred some outside professional fees from its CPA tax advisors.

What are the consequences? Think about where this is going. Facing business activity taxes assessed by four states where we have no presence is bad enough, but 20 states? 30 states? We would have to add staff just to attempt to keep track of these unforeseeable obligations, file the returns, and stay clear of penalties and demands for back taxes. These would, of course, be unproductive employees – a hit to our efficiency. And bear in mind that we are a 100 percent employee-owned company. Any added costs hurt every employee.

And what about the overall impact on the economy? The taxes we pay to states where we have no physical presence come off our net profits. So do the administrative costs. As our net income after expenses is reduced, the taxes we owe to Wisconsin and to the federal government also are reduced. After you factor in both the added taxes and the added administrative costs, both to us and to the states, I doubt that anyone is coming out ahead.

Certainly if other states jump on this bandwagon, we will just be spreading the taxes around, with little, if any, net benefit to anyone.

As a small manufacturer in the US, we face many threats from competitors outside our borders. We continue to be successful by staying lean and smart. Adding unnecessary headcount to administer programs like activity taxes makes us less competitive with overseas companies.

For many years, it has been the presumption that businesses pay taxes only in states where they have physical presence and receive government services. We believe the Congress should act to preserve this standard.

Tax Reform: What It Means for State and Local Tax and Fiscal Policy

United States Senate Committee on Finance

Wednesday, April 25, 2012, 10:00 AM

215 Dirksen Senate Office Building

Washington, D.C.

Submitted by:

Homer Nicholson, OML President and Mayor, Ponca City, OK

and

Carolyn Stager, Executive Director

Oklahoma Municipal League

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(405) 528-7515 or (405) 514-6712

The Oklahoma Municipal League (OML) is an association of cities and towns representing 462 municipalities throughout the state of Oklahoma.

OML very much appreciates the opportunity to provide written testimony to the United States Senate Committee on Finance regarding S. 1832, The Marketplace Fairness Act.

A high priority for the OML is supporting the Marketplace Fairness Act that will allow states and local governments to collect taxes on sales made through e-commerce. This has been a consistent and long-standing position for our association that dates back to the catalogue sales. With the changing environment and more and more shopping occurring on-line, this continues to create a major unfair disadvantage to our main street, brick and mortar businesses. Unlike arguments in the past, technology is now readily available to determine the appropriate tax rates without undue administrative or costly burdens on retailers.

Cyber Monday 2011 was the largest online shopping day in history with $1.25 Billion spent. While that may not sound bad for our national economy, it has a huge negative impact on the businesses and municipalities in Oklahoma.

Businesses are the driving force behind the Oklahoma economy. Oklahoma businesses are required to collect sales tax from their customers and remit to the state where it is distributed to the municipalities. Unlike these businesses, many out-of-state online companies have been exploiting a tax loophole and do not charge sales taxes at the time of purchase. There is currently a voluntary compliance by several out-of-state businesses 'if' they have nexus or a presence in the state. Under the Streamline Sales Tax (SST) Volunteers, the State of Oklahoma and local governments received $17.6 Million in fiscal year 2011. However, this is just a drop in the bucket compared to the estimated loss of $185 to $225 Million per year.

Local businesses also incur a great percentage of overhead costs --- paying employees, utility and facility costs --- than their online only competitors. Main Street businesses are the backbone of our local economy and employ our neighbors, sponsor our children's little league teams and are involved in civic and community organizations. Local retailers in Oklahoma have expressed concern about customers coming into their stores and testing products, only to leave and later purchase the item online. They understand that it's not always possible or convenient to buy locally, but they do want to compete fairly.

This burden is likely felt more heavily in Oklahoma than any other state in that we are the only state where municipalities do not receive ad valorem taxes for general operations. In Oklahoma ad valorem revenue is dedicated primarily to schools and counties. While none of us likes to hear the word "taxes', especially at this time of year, it is important to remember that Oklahoma cities and towns are overly dependent on local sales tax to fund all their basic services: police, fire, roads, parks, libraries, road maintenance and much more.

Inconsistent or non-growth sales tax revenue makes it difficult for municipalities to offer consistent services year-to-year. Bipartisan legislation currently pending in congress S. 1832 "Marketplace Fairness Act", if passed, will solve the problem of having internet sales increasingly affect the collection of local and state sales tax. It is important to remember **this is not a new tax**. These are taxes already owed, but have simply gone uncollected.

The Oklahoma Municipal League respectfully request our Oklahoma Senator, Dr. Coburn, and this Committee to assist in moving S. 1832 out of the Finance Committee. Your support of this bill will go far in closing this loophole. A level playing field will ensure that competition between local businesses and their online competitors is fair.

The OML extends our sincere thanks & appreciation to Senators Enzi, Durbin & Alexander and their staffs: Randi, Eric, Corey, Beth, Allison & Michael for their tenacity and persevering in advancing this legislation.

Rochester

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OPPENHEIMERFUNDS, INC., STATEMENT
FOR INCLUSION IN THE RECORD OF THE APRIL 25, 2012, HEARING:
"TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY"

May 8, 2012

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin G. Hatch
Ranking Member, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Senator Hatch:

For more than 115 years, the U.S. Government has recognized that tax exemption, as one industry expert put it, is the "bedrock" on which the municipal bond market operates.

This is as true today as it was in 1895, when the U.S. Supreme Court ruled that any interest earned on a state bond was immune from federal taxation (*Pollack v. Farmers' Loan and Trust Company)*. The Court's ruling remained intact through the ratification of the Sixteenth Amendment, which enacted the first Internal Revenue Code, and the passage of the Revenue Act of 1913.

Significantly, the tax exemption has even held steady since 1988, when the U.S. Supreme Court decided that Congress could authorize the taxation of municipal bond securities. That Congress has repeatedly and wisely chosen to leave intact the tax exempt status of these securities suggests the overriding truth expressed in the concurring opinion offered in 1988 by Justice John Paul Stevens: the Court's decision, he wrote, "expresses no opinion about the wisdom of taxing the interest on bonds issued by state or local governments."

In this time of difficult economic conditions, it is understandable that Congress would consider a variety of measures to help resolve the country's growing deficit. However, the tax exempt status of the income generated by municipal bonds should not be among the solutions that this Committee endorses or that Congress pursues. It is imperative that this Committee recognize and consider the negative and unintended consequences that would develop were Congress to alter the tax status of municipal bonds, including consequences to individuals, to the state and local governments that issue bonds, to the communities in those municipalities, and to the U.S. economy, the health of which is integrally tied to the health of the country's credit and equity markets.

We feel strongly that the potential costs to U.S. society of any change in the tax exemption on municipal investment income is far greater than the potential tax revenues that could be collected if the tax

exemption were to be eliminated. With interest on tax-exempt municipal bonds totaling approximately $50 billion per annum, federal tax collections could be $7.5 billion higher were all of this income to be taxed at the current rate for capital gains and dividend income. However appealing this increase might be, it pales in comparison to the damage that could result from such a decision.

We expect that a change in the tax-exempt status of the income generated by municipal securities would:

- Cause the aggregate market value of existing bonds to decline by $200 billion, according to one industry expert, destabilizing a $3.74 trillion market that serves millions of individual investors and tens of thousands of municipal issuers.
- Exacerbate the lingering and troubling effects of the Great Recession and potentially interfere with our nation's ability to achieve robust economic growth.
- Introduce new uncertainties into a population that is already highly concerned about job security, future saving rates, the value of their homes, the European debt crisis, future tax rates, and the hesitance of U.S. industry to deploy capital despite record low interest rates.
- Raise the true borrowing costs borne by state and local governments that seek to collect sufficient revenues to pay for the essential services their constituents require and for the immediate and longer-term infrastructure needs of their communities. These state and local governments have already been sorely tested by the economic downturn of the past few years.
- Create immediate economic hardship for the millions of fixed-income investors whose budgets and lifestyles depend on the interest income from their municipal bond investments and the tax benefit the exemption provides.

The Rochester, N.Y.-based municipal bond team of OppenheimerFunds, Inc., a leader in the municipal market industry with more than $32 billion in assets under management as of April 30, 2012, respectfully asks this Committee to recognize the magnitude of the difficulties that would emerge were it to alter the long-standing tax-exempt status of municipal investment income. In doing so, we believe, the Committee will agree that the consequences of any such decision or recommendation would be harmful to the marketplace, the economy, the state and local governments that rely on public financing, and the individual investors whose dollars enable continued and necessary improvements to the nation's infrastructure.

AN OVERVIEW OF THE U.S. MUNICIPAL BOND MARKET

The large and stable municipal bond market is dominated by individuals seeking competitive levels of income. Of the $3.74 trillion in outstanding municipal debt (as of 12/31/2011), about 80 percent (or $3 trillion) is exempt from taxation at the federal level and in the states and local municipalities where it was issued.

The market includes tens of thousands of issuers – from small towns to large metropolises. These issuers rely on public financing to support a wide range of civic projects: renovating a community's firehouse, rebuilding at Ground Zero, creating world-class hospitals, expanding the facilities at established universities, building new bridges and repairing roadways, and providing adult living facilities for America's aging population, to name a few of the myriad uses for municipal financing.

Millions of individual Americans have invested in the municipal market, attracted by the tax exemptions that apply to municipal investment income and by the wide range of investment opportunities, which include individual bonds, municipal bond mutual funds, separately managed accounts (SMAs) and exchange-traded funds (ETFs). Mutual funds with lower initial investment requirements, for example, have enabled individuals with fewer assets to invest and benefit from the yields that municipal bonds offer and from the expertise of professional portfolio managers and credit analysts. The ability to buy and sell fund shares at will has also attracted individual investors to these types of investments.

By allowing the tax exemption for municipal bond interest income, the federal government has encouraged investors to participate in this market. This practice is consistent with other tax advantages that the government has tacitly endorsed, including the provisions related to individual retirement accounts, health savings accounts and 529 plans, all of which serve to encourage individuals to invest for their future well-being.

While the municipal market holds special appeal for high-net-worth individuals and senior citizens, in recent years it has become increasingly attractive to a broad range of taxpayers, according to the Joint Committee on Taxation (JCT). According to that committee's April 24, 2012, report, a growing number of Americans now qualify for the federal tax benefits associated with municipal bond investing. Specifically, any taxpayer with a 2011 marginal income tax rate of more than 7.5 percent would benefit more from an investment in a high-grade municipal security than from an investment in a AAA-rated corporate bond. In the period from 2008 through 2010, the federal tax benefit on municipal income only reached taxpayers with marginal rates ranging from 13 to 16 percent. In the two decades prior to 2008, the average was 21 percent, with annual figures ranging from 17 to 27%.

The American Recovery and Reinvestment Act of 2009 has made it easier for commercial banks to invest in municipal securities. Collectively, banks now represent the fifth largest holder of municipal debt, according to new Federal Reserve Board data. They see municipal bonds as a means to collect levels of investment income that exceed the interest they pay to depositors. Additionally, high levels of income have attracted "cross-over borrowers," including foreign investors who do not qualify for the federal tax exemption.

Short-term initiatives, such as the establishment of federal tax rebates for municipalities that issued taxable Build America Bonds ("BABs") in 2009 and 2010, demonstrated the potential to improve the fiscal conditions at the state and local level but were attractive to these municipalities only to the degree that they lowered the municipalities' debt obligations. Investors liked the taxable BABs for the same reason they like tax-exempt municipal securities: both enable investors to collect higher levels of income than other investments offered. However, were the federal tax exemption on municipal securities to disappear, the appeal of municipal bonds would fall, lowering bond prices and leading to higher debt obligations – and more economic hardships – for the states and municipalities that need public financing. The consequences for local entities and taxpayers – which could include increases in sales, income and property taxes as well as reductions in essential services – would likely be harsh.

The overall fundamentals of the municipal bond market have remained remarkably stable in recent years. The municipal bond market was not among the perpetrators or originators of the 2007-2008 credit crisis. That period, which certainly created significant market turmoil and volatility, including in the municipal markets, was in large part the result of collateralized mortgage obligations and other derivative products built on the faulty premise that housing prices would continue to rise and would only fall in geographically isolated markets rather than a broad, coast-to-coast collapse. When housing prices began to fall across the nation, the errant premise came to light – with harsh ramifications for

investors worldwide. On the tails of these difficult years, investors began to hear frequent reports about distressed municipal bonds. Lost in those reports are the facts: that the historical default rates among municipal bonds have been extremely low – both as a percentage of total debt outstanding and in comparison to default rates on bonds issued in the corporate sector. Few reports mention that the recovery rates on the relatively few bonds that had monetary defaults were significantly better than the recovery rates on defaulted corporate securities.

Further, the situations that have captured significant media attention in recent years – Harrisburg, Pennsylvania; Vallejo, California; Jefferson County, Alabama, among others – represent a very small slice of the overall muni market. These are anomalies based on very specific and localized issues that elected officials failed to address with an appropriate sense of urgency. Had the officials acted responsibly, we believe, these situations could have been avoided.

The strength and breadth of this market – which is vital to the fiscal well-being of millions of investors and thousands of communities – would be damaged by any change in the tax-exempt status of municipal bond investment income. The immediate impact to the aggregate market value of existing bonds has been estimated by a notable industry expert at $200 billion. The long-term impact is likely immeasurable.

ECONOMIC RAMIFICATIONS AND UNCERTAINTY

Changes to the tax status of municipal investment income would have an adverse effect on the market for municipal securities and this, in turn, would harm the fledgling U.S. economy. The concerns over the near- and long-term health of the economy must continue to be a top priority for Congressional leaders.

In addition, the country continues to be plagued by stubbornly high unemployment levels. The situation of late has been made worse by the growing need of older Americans to remain in the job market as a means to maintain their standard of living, pay their mortgage and build assets toward a delayed retirement. A new study by the University of Michigan Institute for Social Research shows that 40 percent of older Americans have postponed retirement, hoping to recover some of the wealth their households lost between the summers of 2008 and 2009. Other research indicates that middle-income employees, often among the hardest hit during recessionary periods, experienced sharp declines in the Great Recession. This time, however, the rebound in this cohort has not yet materialized. Additionally, it is already clear that many of this season's newly minted crop of college graduates will struggle to find meaningful and financially rewarding employment – as did last season's graduates.

The national housing crisis has proven far more persistent than was expected at its onset. The notion of having an "under water mortgage" has become part of the vernacular, as millions of homeowners are discovering that the amount they owe on their loan vastly exceeds the declining value of their property. Others are choosing to abandon their homes or have simply stopped making payments, hopeful that the backlog of foreclosures will buy them some time. Meanwhile, as construction of new homes has stalled, the nation's developers, contractors, builders and suppliers are feeling an immediate impact. Additionally, the spending that would have occurred near construction sites has not materialized.

The situation has also been difficult for people who believed they were ready to enter the housing market. In many communities, prices reached significantly more affordable levels but were unattainable because of tighter lending guidelines at many financial institutions. The guidelines seemed prudent relative to the go-go years of jumbo mortgages and mortgage brokers offering adjustable-rate loans with low "teaser" rates, but the reins on credit effectively narrowed the pool of potential buyers.

Ironically, this tightening has occurred even as the Federal Reserve continues to seek to spur the economy through a historically low Fed Funds target rate, which effectively determines short-term interest rates.

Despite the Fed's encouragement, individuals, small businesses and corporations have been hesitant to borrow or to invest their capital. Concerns about the tepid growth of the economy have created widespread reluctance among many to add debt or reduce capital levels. The predominant thinking, it seems, is to wait until robust growth is an economic norm.

This uncertainty about creating new debt obligations or investing hard-earned capital has had a detrimental effect on the U.S. job market. Job creation has been weak and, for many, job security fleeting. Additionally, many Americans remain uncertain about the degree to which their income and savings will align with future financial needs. The loss of assets that occurred primarily between 2007 and 2009 is still a fresh memory, and a lingering skittishness imbues the spending decisions of many.

Several potential changes at the federal level serve to aggravate the uncertainty. Individuals may be facing new costs related to the Affordable Care Act of 2010, the legality of which will be decided by the U.S. Supreme Court. The future of the tax rate changes of 2001 and 2003, the so-called Bush-era Tax Cuts, will once again be debated in Washington, as it was at the end of 2010. A significant number of investors are now facing uncertainty about their tax status, including those who may or may not be subject to the alternative minimum tax, those who may find themselves in a higher tax bracket based on legislated decisions, and those who worry that the deduction for mortgage interest may be short lived.

Compounding these concerns are the fears that the economic troubles in the European Union will either spread to the United States and/or continue to depress economic conditions worldwide, with negative consequences on U.S. trade. It seems likely that the Euro debt crisis has the potential to further derail or delay the spending decisions that America's chief executive officers might otherwise make.

Finally and perhaps obviously, the pending 2012 presidential and Congressional elections create further uncertainty, as unknown outcomes often do. Clearly, the election results could lead to changes in many areas of American life and have a wide impact on federal, state and local economies.

THE MUNICIPAL MARKET'S IMPORTANCE TO STATE AND LOCAL GOVERNMENTS

In his hearing statement, Senator Baucus encourages this Committee to "ask what else we can be doing to efficiently help state and local governments maintain sustainable budgets." We concur with the conclusion he has reached: "Let us improve the tax code to create growth and make the U.S. more competitive. And let us do this in a way that improves federal, state and local budgets." However, we are extremely concerned that any move to reduce or eliminate the federal tax-exemption would be detrimental to this stated goal. The Committee should be equally concerned.

The ability of elected officials at the state and local level to govern effectively depends, in part, on their ability to borrow at interest rates that their municipalities can afford. It is essential to manage a municipality's debt obligations, and the need to maintain unfettered access to the credit markets has led many an elected official to make the tough decisions that ensure that general obligation debt obligations are paid on time and in full.

State and local governments are active issuers of tax-exempt municipal debt, offering in the average year $384 billion in tax-exempt bonds, based on data from 2002 to 2011. Additionally, as the testimony by a consortium of civic groups points out, these governments oversee three-quarters of the nation's

infrastructure spending. Were Congress to eliminate or reduce the tax exemption on municipal bond issuance, borrowing costs would rise, creating a strong deterrent to municipal borrowing. As the civic groups accurately states, "Without access to this type of financing, the cost to taxpayers for providing schools, libraries, public buildings and hospitals, roads and bridges and sewers and waterways would be much greater."

Without the exemption, municipalities would become less willing to make the required investments in their infrastructure and/or less able to provide essential services to their constituents. The deterioration in communities – as infrastructure maintenance is put off and as Americans lose the services on which so many depend – would have negative repercussions throughout our country. (Similarly, as Senator Hatch observes, the administration's proposal to limit the federal tax exemption to 28 percent "would raise borrowing costs for state and local governments.")

The existence of the federal tax exemption on municipal bond interest income provides clarity about borrowing costs, enabling local government leaders to establish realistic budgets that reflect anticipated revenues as well as their own municipality's needs for services. Changes to this federal tax exemption would likely cause borrowing costs to increase and funding for important civic initiatives – for example, K-12 education – to be lowered.

As the Congressional Budget Office explains, "The lower the rate of interest that state and local governments must pay on their debt, the more funds they have available to provide government operations and the greater the amount of debt they can service and, therefore, the greater the amount of investment they can make." Conversely, if the tax exemption were to be reduced or eliminated, taxpayers would have less motivation to invest in municipal projects and, as a result, municipalities would have to offer higher yields to entice them. Projects would either create higher debt obligations or they would be downsized as a means to lower overall borrowing. Neither option is in the best interest of a municipality or its taxpayers.

The tax exemption provided on municipal income has several other benefits, among them:

- Enabling elected officials to be responsive to their own constituents by accessing lower cost public financing to enhance areas of local importance, e.g., education initiatives, transportation projects and utility upgrades.
- Ensuring local accountability for the success and cost-efficiency of infrastructure projects.
- Preventing delays that would likely develop if it became necessary for the federal government to provide funds that municipalities could no longer afford to raise
- Avoiding the bureaucratic red tape and eliminating the uncertainty that typically accompanies federal financing, grants and subsidies of infrastructure projects. These initiatives often have short durations and may spark lengthy debates. Only true emergencies – e.g., bridge collapses and the like – lead to an immediate access to funding.

The Committee has indicated that alternatives to the tax exemption for municipal bond income may resolve what some see as an unnecessary loss of federal tax receipts. We concur with the testimony offered by the National Governors Association: "No effective substitute for tax-exempt bonds exists. Investor demand for alternatives ... is insufficient at best. Taxable direct subsidy bonds permitted for issued during 2009 and 2010 [Build America Bonds] only complemented tax-exempt bonds, but only when the taxable bonds provided a subsidy far greater than the benefit to investors from interest

deductibility. If municipal bond interest were taxable, or if the federal tax-exempt status on state and local bonds were capped or lifted, the cost of borrowing, and therefore of financing infrastructure, would rise for states. Ultimately, this cost would be borne by taxpayers through reduced infrastructure spending, higher taxes or both."

State and local governments have only just begun to find their footing again, after struggling for many years to create balanced budgets. The hardships created as elected officials were forced by declining revenues to cut essential services have had significant impact in their communities. Only recently have they begun to restore some of these services. However, with sales, income and property tax levels still at depressed levels, the ability to lessen their debt-service obligations is paramount. The appropriate course is to maintain the tax exemption on municipal income that enables them to do so.

THE MUNICIPAL MARKET'S IMPORTANCE TO INVESTORS

Individual investors own 74.8 percent of municipal debt and are thus the largest stakeholders in the municipal bond market. (According to the Federal Reserve Board's data for 2011, 50.2 percent of municipal bonds is held by individual households; 14.5 percent is held in their mutual fund investments, 7.9 percent is held in their money market fund investments and 2.2 percent is held in their closed-end fund investments.) Municipal investments attract these individuals because the interest income that is generated can be put to use immediately—to supplement their budgets, enhance their lifestyles or reinvest in the U.S. economy.

In recent years, municipal investments of all maturities have provided higher levels of income than has been available through banks and other financial institutions. These higher rates motivate Americans to invest and help them create financial cushions for their families and prepare for their later years. Additionally, the mutual fund industry now offers a wide range of products, designed to give investors convenient choices that can be aligned to their own risk tolerance and financial objectives. Many of these have relatively low barriers to entry compared to other investment products.

As short-term interest rates have become negligible – and sometimes negative for short-term Treasuries – many investors have shifted their assets to the municipal bond market. The attraction has been twofold: the abnormally higher nominal yields and the after-tax benefits created by the federal tax exemption on interest income. To alter the terms of these investments retroactively would be a disservice to the American investor. Further, it would undermine the government's efforts to retain the trust and respect of its citizenry. As the municipal bond research director at a leading U.S. investment firm told *The Bond Buyer* in February 2012, "Once the trust between the federal government and the bondholder is breached through this process, people are going to assume that the government can revisit this at any time."

The current tax code features a graduated tax rate scale: individuals with higher income levels are initially placed in tax brackets with higher rates. Consistent with this approach is the notion that individuals who pay a higher income tax rate should also benefit from a tax exemption that is larger (in dollars) than the tax exemption for individuals who pay at lower rates. Implementing a uniform subsidy for bondholders, as Senator Baucus believes should be considered, runs counter to basic tenets of the U.S. tax code. Unless and until tax reform addresses differentiated income tax brackets and differentiated rates on capital gains and dividend income, the application of a uniform subsidy on investment income should be off the table.

In addition to the benefits that accrue to individuals because of the tax exemption, investors benefit from their involvement in their community's priority developments. Helping to finance local projects that create local jobs gives individuals a new sense of civic pride and strengthens their ties to their communities. Even the process of placing bond authorization initiatives on the ballot can inspire individuals to participate in civic proceedings.

To foster greater understanding of the benefits associated with municipal bond investing, industry groups, financial institutions, investment firms and Nationally Recognized Statistical Rating Organizations (NRSROs) have created and continue to disseminate a wealth of information. Additionally, national newspapers, business journals and magazines devote considerable resources to covering the variety of investing opportunities that are available to individuals seeking tax-advantaged income.

Given the important role that municipal investing already plays in helping individual investors meet their financial objectives, it would be a mistake to alter the federal tax exemption on municipal interest income.

CONCLUSION

Recommending any change to the federal tax exemption on municipal interest income would have detrimental effects on the economic growth, the fiscal health of state and local governments, and the ability of individual investors to stabilize their own finances.

As an industry leader in the municipal bond market, OppenheimerFunds believes it is well positioned to speak to the important role that municipal bonds play in this country. They allow states and local governments to secure more affordable public financing for infrastructure projects that serve their constituents, and they help individual investors supplement their budgets, prepare for their later years, enhance their lifestyles and/or reinvest in the U.S. economy. While the media has reported on the impact of a few troubled municipalities, the $3.74 trillion municipal market is fundamentally strong. Headlines about current developments in the market have wrongly played to Americans' worst fears – that another market crisis is around the corner and that their assets may once again face considerable risk.

Like other fund managers, OppenheimerFunds devotes considerable resources to analyzing the creditworthiness of individual bond offerings and creating portfolios designed to mitigate risk: interest-rate risk, idiosyncratic risk, geographic risk and headline risk. The interests of our shareholders come first, and it is their interests that lead us to advocate in favor of retaining the federal tax exemption on municipal bond interest income.

In his testimony before this Committee, Professor Walter Hellerstein refers to the Hippocratic Oath – "first, do no harm." Senator Hatch also mentions this oath in his member statement. A change to the tax exemption of municipal bond interest income would certainly harm the economy, create turmoil in the marketplace, undermine the ability of state and local governments to address their own communities' infrastructure needs and adversely affect individual taxpayers. The issue should be tabled.

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

May 9, 2012

Honorable Max Baucus, Chairman
Honorable Orrin Hatch, Ranking Member
United States Senate, Committee on Finance
Attn: Editorial and Document Section
Room SD-210
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Washington, DC 20510-6200

Re: April 25 Senate Finance Committee Hearing on *Tax Reform: What It Means for State and Local Tax and Fiscal Policy*

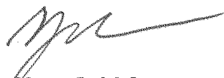
Dear Chairman Baucus, Ranking Member Hatch and Members of the Committee:

The Organization for International Investment ("OFII") is pleased to submit comments for the recent hearing entitled, "Tax Reform: What it Means for State and Local Tax and Fiscal Policy." OFII believes the Committee has an important opportunity in the context of corporate tax reform to address a growing concern for global investors in this country: the attempt by certain states to exert economic nexus authority over foreign companies with no physical presence in the United States – simply based upon the activities of affiliated companies, such as royalty payments from a U.S. subsidiary to its foreign parent company.

Such tax treatment violates the spirit of bilateral tax treaties, risks disputes with key trading partners, and damages the competitiveness of the United States as an investment location. To address it, OFII urges the Senate to consider H.R. 1439, the Business Activity Tax Simplification Act ("BATSA"). This bipartisan legislation would synchronize nexus standards across all 50 states and help provide fairness and certainty for international companies attempting to do business in America.

Attached is a written statement on BATSA submitted to the House Judiciary Committee, which held a hearing in April of 2011 to examine the merits of the legislation. The committee subsequently approved BATSA by voice vote in July of 2011. If signed into law, OFII believes BATSA would make the United States a more attractive location for inward foreign direct investment.

Sincerely,



Nancy L. McLernon
President & CEO
Organization for International Investment

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

Organization for International Investment ("OFII")
Written Statement for the Record of the House Judiciary Courts, Commercial and Administrative Law Subcommittee Hearing on H.R. 1439: the Business Activity Tax Simplification Act of 2011

April 13, 2011

The Organization for International Investment ("OFII") appreciates the opportunity to comment on H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA"). OFII urges the Committee to promptly mark-up and favorably report out BATSA in order to address a growing concern for international businesses – the increasing number of U.S. states that have been inappropriately aggressive in attempting to increase their share of the global tax base of multinational companies by expanding their fiscal jurisdiction outside the United States. Expansive interpretations of economic nexus by U.S. states threaten to impose significant double taxation on non-U.S. companies and make the United States a less competitive location for global businesses to invest and create jobs. The exterritorial taxation resulting from these interpretations is inconsistent with U.S. federal income tax laws, international norms of taxation and violates the spirit of U.S. double taxation treaties. Such tax treatment is fundamentally unfair and risks harmful and unnecessary disputes with our major trading partners.

OFII represents the U.S. operations of companies headquartered abroad; companies which directly employ over 5 million Americans across the 50 U.S. states. OFII promotes fair and equal treatment for these "Insourcing" companies in U.S. federal and state law. We undertake this mandate with the goal of making the U.S. an increasingly attractive market for international companies to invest and create American jobs. At a time when the U.S. Congress is considering ways of attracting new business investment, preserving fair and equitable tax treatment at the federal and state level is more critical than ever.

I. Insourcing Companies in the United States

As illustrated in the attached membership list, and by the facts below, "insourcing" companies, play a major role in our nation's economy, providing critically important jobs (and the associated tax base) in communities across the country.

Some salient facts about insourcing companies:

- U.S. subsidiaries employ 5.6 million Americans — 4.7 percent of total U.S. private sector employment;
- U.S. subsidiaries account for 6 percent of total U.S. GDP;

- U.S. subsidiaries support an annual payroll of $408.5 billion — with average compensation per worker of $73,023, about one-third higher than compensation at all U.S. companies;
- U.S. subsidiaries heavily invest in the American manufacturing sector; with nearly 38 percent of jobs at U.S. subsidiaries are in manufacturing industries, accounting for about 16 percent of total American manufacturing jobs;
- U.S. subsidiaries manufacture in America to export goods around the world — accounting for more than 18 percent of all U.S. exports, or $232.4 billion;
- U.S. subsidiaries pay nearly 17 percent of total U.S. corporate tax payments, according to the IRS, a larger share than their relative size in the U.S. economy;
- U.S. subsidiaries have a larger percentage of workers covered by a union collective-bargaining agreement than other U.S. companies — 12.4 percent of employees at U.S. subsidiaries compared to just 8.2 percent at other U.S. firms.

II. Extraterritorial State Taxation Risks Economic Benefits

The significant contributions insourcing companies bring to the U.S. economy are a direct result of the U.S.'s open investment environment, which treats these companies and the Americans they employ on a level playing field with their domestic competitors. The growing trend of U.S. states moving to extraterritorial taxation of non-U.S. companies undermines these contributions.

- U.S. states' aggressive fiscal behavior: (1) can deter foreign investment in the U.S. due to increased uncertainty for double taxation; (2) disrupts the international tax treaty network; (3) could encourage retaliatory foreign legislation; and (4) creates uncertainty, complexity, inadministrability and substantial costs.

- It is important that the U.S. government maintain its ability to speak with one voice on international fiscal matters and not be undermined by the efforts of individual states.

- States have other tools to combat perceived fiscal abuse. Current state actions are inappropriately sweeping in legitimate business transactions.

- When U.S. states have taken extraterritorial tax actions in the past, many U.S. treaty partners have issued strong objections and even adopted blocking statutes and laws mirroring this inappropriate tax treatment for U.S. multinationals.

U.S. states are expanding their fiscal reach in two different ways: (1) "economic nexus"; and, (2) expanded "water's edge" provisions.

1) Economic Nexus

U.S. double taxation treaties require a physical presence (usually defined as property, employees, etc.) in Country A before Country A can levy an income tax on a company incorporated in Country B. However, since U.S. states are NOT bound by U.S. tax treaties, some have adopted "economic nexus" provisions that impact foreign parents and affiliates incorporated in other countries.

Specifically, approximately 25 U.S. states have already adopted an expansive "economic nexus" theory, which does **NOT** require physical presence to assert taxing authority (see attached map).

For instance, a company incorporated in the U.K., with no physical presence or employees in the U.S., may find itself subject to tax in a particular U.S. state.

Example: Recently, New Jersey has sent tax assessments directly to certain foreign parents of U.S. subsidiaries under an "economic nexus" theory. New Jersey authorities claim they have a right to tax these foreign companies merely because they have received royalty payments from U.S. affiliates doing business in New Jersey. The foreign parent companies have NO physical presence in New Jersey. The international business community has been extremely active in fighting this effort. There has been no resolution to date.

"Economic nexus" provisions were originally developed to deter U.S. companies from directing intangible revenue to domestic affiliates located in states that do not tax this income, thus reducing their overall tax burden. However, U.S. states have other provisions to effectively combat such abuses and the use of a broad "economic nexus" theory unfortunately sweeps in legitimate business transactions.

2) Expanded "Water's Edge"

Some U.S. states have taken the position that **all** foreign affiliates of a company doing business in a state should be included in a "combined return," **regardless** of whether such foreign affiliates have physical presence or nexus in that state. However, most states with "combined reporting" allow companies with affiliates in other countries to make a "water's edge" election. Under a "water's edge" election, the combined group – i.e., the companies that are taxable in the state - is comprised only of those affiliated corporations within the "water's edge" of the United States (the 50 states and the District of Columbia).

Various U.S. states are now expanding the definition of "water's edge" beyond the Atlantic and Pacific Oceans. Specifically, foreign affiliates that earn a certain percentage of income from U.S. sources are being deemed part of a state's "combined group" for tax purposes - even if the U.S. federal government does not subject such foreign affiliate to income taxes.

Example: Effective beginning 2009, West Virginia enacted a Combined Reporting Statute that includes an expanded definition of a "water's edge" election. Specifically, the "water's edge" group would include foreign companies that receive more than 20% of their income from certain U.S. sources. Importantly, these foreign companies have no physical presence or nexus in the U.S. Therefore, foreign companies that are already subject to tax in their home country and that are not subject to federal income taxes would be required to file a West Virginia tax return and pay tax in West Virginia. The international business community is currently embroiled in an effort to change the law, with no resolution to date.

Acting on an expanded "water's edge" approach in the 1990s, California attempted to bring foreign affiliates of U.S. companies into its tax base even though they had no physical presence in the U.S and were subject to tax in their home countries. This proposal drew strong objections from U.S subsidiaries of foreign companies and from U.S. treaty partners who rightly viewed California's proposal as a revenue grab, and an erosion of treaty protections for its corporate citizens. Many countries raised serious concerns about California's efforts and the U.K enacted retaliatory legislation against California-based companies. As a result, California dropped its extraterritorial aspirations and adopted a "water's edge" election whereby a U.S. combined group could elect to limit such group to affiliates with physical presence or nexus in the U.S.

CONCLUSION

As stated above, a growing number of U.S. states have adopted aggressive "economic nexus" theories and expanded "water's edge" statutes that increase the risk factor of double taxation for foreign parents and affiliates of U.S. subsidiaries. Although U.S. double taxation treaties are meant to offset these risks, U.S. states are NOT bound by the treaties. As a result, foreign companies that have no U.S. physical presence and are not subject to federal income taxes may find themselves subject to double taxation by their home country and U.S. states. This creates an unlevel playing field since nearly all U.S. double taxation treaties bind the non-U.S. treaty partners' sub-national governments, such as cantons, provinces and states.

Moreover, this approach enables states to conduct their own individual foreign fiscal policies at the detriment of investment flows into the U.S., endangering and disrupting the treaty network, and violating the international norms respecting national fiscal jurisdictions. There is no U.S. Constitutional prohibition that would prevent the U.S. federal government from including the states in the treaties, only a potential political issue. It is important that the U.S. government maintain its ability to speak with one voice and not be undermined by the efforts of individual states.

The potential for damage from this aggressive approach is significant. Current economic conditions are provoking U.S. states to expand their fiscal jurisdictions beyond U.S. borders with overly broad legislation. It is extremely important for the U.S. Congress to address this aggressive behavior.

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

OFII is the only business association in Washington D.C. that exclusively represents U.S. subsidiaries of foreign companies and advocates for their non-discriminatory treatment under state and federal law.

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XL Global Services
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April 20, 2012

Honorable Max Baucus, Chairman
Honorable Orrin Hatch, Ranking Member
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Re: April 25 Senate Finance Committee Hearing on *Tax Reform: What It Means for State and Local Tax and Fiscal Policy*

Dear Chairman Baucus, Ranking Member Hatch and Members of the Committee:

Thank you for holding a hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy. In that context, I would urge you to consider the issue of business activity tax nexus. I testified on the issue before the House Judiciary Committee last year, and I am attaching a copy of that testimony for inclusion in the hearing record.

As discussed in my testimony, many states, desperate for revenue, regularly assess millions of dollars a year in corporate income and similar taxes simply because companies have what they call an "economic presence" there. This includes customers with credit cards, software or intangibles, such as trademarks, trade names, and advertising or, like us, franchise agreements.

The U.S. Supreme Court has suggested more than once that a physical presence, not merely an economic presence, is needed in order for a state to assess such taxes. But Congress has not yet clarified that nexus standard.

I respectfully urge Congress to act now to enact H.R. 1439, the Business Activity Tax Simplification Act ("BATSA"). The bill, which has strong bipartisan support, would establish a single, uniform nexus standard for all states, so that businesses like mine will no longer have to wonder about their tax liability, nor would they have to wrestle with unjustified and unexpected tax assessments from states where they do not have a single employee, piece of inventory or even an office. BATSA would clarify what the U.S. Supreme Court decided two decades ago in the sales tax arena: that a state can only tax out-of-state companies if they have a substantial connection with that state. If signed into law, BATSA would encourage business development and job growth and put a stop to decades of unnecessary and expensive compliance costs and litigation.

Sincerely,

Corey Schroeder, CFA

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Statement of Corey Schroeder
Vice President & CFO, Outdoor Living Brands, Inc.

United States House of Representatives
Subcommittee on Courts, Commercial and Administrative Law

April 13, 2011

Good afternoon Chairman Coble, Ranking Member Cohen, and members of the subcommittee. My name is Corey Schroeder, and I am grateful for the opportunity to speak today in support of the *Business Activity Tax Simplification Act of 2011*, or "BATSA," and the specific impact the current state income tax reporting environment has on my company, Outdoor Living Brands and on franchise businesses in general.

I am the Vice President and Chief Financial Officer of Outdoor Living Brands, Inc., which is located in Richmond, Virginia and was formed in 2008 to acquire franchise businesses in the outdoor living category. We currently operate three brands representing 181 franchise locations in 34 states. Despite this reach, we are a small business with $4.6 million in revenue and only 28 employees.

During my remarks today, I will highlight why small businesses require a federal solution to bring greater certainty to compliance with state tax laws. I will share with you the experience of our company in navigating the unpredictable nature of state nexus decisions across multiple jurisdictions. Finally, I will provide insight into how the uncertainty of these nexus decisions impact the hundreds of thousands of franchise businesses in the United States.

Our franchise system is an active member of the International Franchise Association (IFA). As the largest and oldest franchising trade group, the IFA's mission is to safeguard the business environment for franchising worldwide. The IFA represents more than 90 industries,

including more than 11,000 franchisee, 1,100 franchisor, and 575 supplier members nationwide. According to a study conducted by PwC for the IFA Educational Foundation, there are over 825,000 franchise businesses across 300 different business lines providing for nearly 18 million American jobs and generating over $2.1 trillion to the U.S. economy.

Franchised businesses play an important role in the economic health of the U.S. economy, and they are poised to help lead the economy on the path to recovery. The IFA Educational Foundation report shows that the franchise industry consistently outperforms the non-franchised business sector, creating more jobs and economic activity in local communities across the country. Franchising grew at a faster pace than many other sectors of the economy from 2001 to 2005, expanding by more than 18 percent. During this time, franchise business output increased 40 percent, compared to 26 percent for all businesses.

The franchise model allows companies like Outdoor Living Brands to grow our business concepts in communities across the country by partnering with local entrepreneurs that invest in and operate their own small businesses. As the franchisor we provide a business concept and operating plan, a brand, licensing of intellectual property in the form of trademarks and copy writes, as well as ongoing training and operational support to our franchisees. Our objective is to serve each local community with our services and help our franchisees build successful small businesses that create jobs.

Outdoor Living Brands an Illustration

This legislation would address a significant issue within the franchising community related to state income tax reporting. The primary issue facing franchisors are the confusing and ever changing rules governing the establishment of tax nexus based on business activities in each state.

When nexus is determined to exist, a franchisor is required to file state corporate income taxes based on the apportioned earnings derived from franchisees in that state. Creating a consistent definition of what constitutes nexus would greatly simplify tax reporting obligations for franchise companies and reduce a significant area of confusion, uncertainty and administrative cost.

While Outdoor Living Brands and franchise companies like ours have franchise locations in many states we do not have operations in those states. Outdoor Living Brands is a company incorporated in the Commonwealth of Virginia. Our physical presence, the development of our brand, the development and training of new franchisees, the support of existing franchisees - everything that makes us a franchisor - takes place in Virginia. The only assets we have in the various states are our franchise agreements, the contract that governs the terms of the relationship between us and our franchisees.

Certain states through legislation or recent court rulings have begun to recognize the mere existence of these franchise agreements and the use of our intellectual property or even the physical existence of our training manuals in their states as establishing nexus. I understand the desire of state tax agencies to generate revenue from out of state businesses from the royalty and licensing revenue derived from those states, especially in the current fiscal environment. However, the logical outcome of this view is for a small company such as Outdoor Living Brands, which conducts materially all of its business in the state of Virginia, would pay less than 10% of our state corporate income taxes to Virginia. Add to this the administrative and cost burden of filing 34 state tax returns and more as we expand to new states.

As a franchise business we are already a highly regulated business. Our franchise offering is prepared in accordance with the rules set by the Federal Trade Commission. Further,

we must comply with additional rules set in certain states. We currently file a franchise tax return in Texas and we have to report on our franchisees' sales tax activity to the State of New York (a recent development). Finally, due to nexus rules we must file state income tax returns in Virginia, Ohio, North Carolina, Arizona, South Carolina, and Minnesota. The filing fees and expenses for audit, legal, and tax services approaches $100,000 per year. That does not include any allocation of my time or the time of our staff to prepare these various filings each year.

Without reform such as that provided by the *Business Activity Tax Simplification Act* the financial and administrative burden associated with tax compliance will continue to grow. This issue diverts resources vital to our business' ability to grow and support our franchisees.

Outdoor Living Brands provides an illustration of how this issue has grown in complexity in recent years. Our business has growth through the acquisition of our three brands. Through those transactions we acquired operations in Virginia, North Carolina, and Ohio. We have since ceased operations in North Carolina and Ohio but our nexus in those states remains for some reason.

Nexus with Arizona, Minnesota, and South Carolina is established purely through the existence of our franchise locations in those states. Most recently South Carolina in 2007 and Minnesota in 2008 established nexus with us through a questionnaire process. Revenue departments from those states sent Outdoor Living Brands a lengthy business activity questionnaire. After checking 'No' to almost every business activity described in the questionnaire it was determined that the existence of our franchisees was sufficient to establish nexus. We were required to file several years of past due tax returns. If we complied within a specified period of time we could have penalties and interest reduced. The South Carolina questionnaire was driven by a then recent court decision, prior to which our company did not

have nexus. I never had any awareness of the nexus with Minnesota until the questionnaire process.

Hopefully, you can see the uncertainty facing franchise businesses surrounding this issue. We do not know with which states we have nexus or why. Further, we have no effective way of determining when those rules change or why.

As a franchise executive I have several ways to manage this issue. The first is to allocate even more of my scarce financial and management resources to proactively determine nexus status with each state. Likely, I would hire a tax consultant to research the remaining twenty-seven states where we have franchisees to explore if our business activity establishes nexus. I expect the states would err on the side of establishing nexus and I will then hire that tax consultant to file tax returns in those states. As you can imagine this is not an attractive approach for a small business like ours. Alternatively, I can take a passive approach and wait until the next business activity questionnaire arrives and start the process with that state, likely adding them to my roster of state income tax filings. The last option which some small business owners have suggested is to ignore the questionnaires and hope that the states are busy enough with larger companies (or those that responded) to overlook them for a couple of years.

Impact on Larger Franchising Business Community

While the United States Supreme Court, through its ruling in *Quill Corp. v. North Dakota*, justified the prohibition of states forcing out-of-state corporations to collect certain taxes unless it had established a physical presence in the taxing state, states have in recent years ignored the ruling and begun establishing an economic nexus standard for taxation. This has created tremendous hardships and confusion for all businesses that use the franchise business model to expand their brand.

Most franchisors own no property in the state in which their franchisees operate, do not maintain offices there, and employ no residents of those states. A franchisor's employees may make occasional visits to its franchisee's place of business to assist the franchisee in opening his or her business and to inspect the franchisee's performance and furnish training advice and guidance, but the duration of such visits normally is limited to a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media.

Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on those states. Meanwhile, like any other enterprise domiciled in a state, a franchisee operating there would pay taxes, be involved in supporting community activities, and create economic opportunities for employees and suppliers who would directly benefit from the existence of the enterprise.

Enactment of BATSA is important to the franchise business community because of the business relationship between a franchisor and its franchisees. Central to that relationship is a shared trade identity. That shared trade identity is established and maintained by the franchisor's license of its trademark, trade dress, and other intellectual property to each of its franchisees. Thus, each of the hundreds of thousands of franchise relationships that exist in the U.S. involves a license of intangible property. The great majority of those licenses cross state lines.

Franchise brands exist across a multitude of political boundaries in most franchise systems, but the franchisor is often a single entity with a clearly defined corporate residence. Some state revenue officials and, increasingly, legislators view the presence of a franchised outlet of a national or regional brand in their state as sufficient for the establishment of an

economic, rather than a physical, nexus of the out-of-state franchisor. It has been incorrectly argued that the mere presence of intangible property in their jurisdiction satisfies the "substantial nexus" requirement under the Commerce Clause for the imposition of state income and related business activity taxes.

In December, the Iowa Supreme Court issued a troubling ruling in the case of KFC Corporation v. Iowa Department of Revenue. The ruling held that the U.S. Supreme Court would likely find that the intangibles that KFC licensed to its Iowa franchisees "would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence.'" This functional-equivalency test goes beyond related case law and is of questionable basis. The physical-presence test is a bright-line test that cannot be met through the "presence" of intangible property in a state. It is difficult to reconcile the Iowa Supreme Court's holding with this test, adding another layer of confusion for companies that are trying to properly assess their tax exposure. Such actions at the state level radically expand the classes of persons, relationships, and transactions potentially subject to state income taxation, and threaten the livelihoods of hundreds of thousands of entrepreneurs who have chosen franchising as the route to small business ownership.

The issue has enormous implications for the businesses engaged in franchising. If permitted, such assessments would subject licensors of intangible property in interstate commerce to income taxation by every state in which goods or services exploiting the licensed intangible property are sold. If a tax return is not filed, no statute of limitations will limit the period for which taxes, interest, and penalties may be due. Such a result would represent a radical departure from the historical understanding of the reach of taxing authority and a

significant increase in the tax liability and burden of compliance of thousands of American small businesses.

If every state where a franchisor has granted franchises may tax its income attributable to that state, non-resident franchisors will be subject to costly compliance burdens and ever-escalating taxes. Under these circumstances, there is no doubt that franchisors will be forced to consider passing this cost of business on to their franchisees by increasing the royalty fees. Under this scenario the party most harmed is the resident franchisee. Thus, enactment of BATSA is critical for thousands of businesses, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Conclusion

Earlier in my career, as an investment banker, I provided professional services to dozens of small businesses in as many industries with far broader business activities compared to Outdoor Living Brands. Few other businesses face the unique complexity in state tax obligations as faced by franchise businesses due to the current nexus environment. The total cost of complying with the current state income tax environment is burdensome. The rules change frequently creating a great deal of uncertainty. The reforms provided by the proposed legislation would greatly improve these conditions for the franchise industry.

I want to thank the members of the Subcommittee on Courts, Commercial and Administrative Law for the opportunity to participate in today's important hearing on the *Business Activity Tax Simplification Act*. It is my hope that we can work together to pass this legislation to address the unnecessary hardship that thousands of franchise businesses face across this country when it comes to compliance with state tax laws.

Thank you and I look forward to answering any questions you may have.

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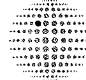


Partnership for New York City

TESTIMONY SUBMITTED TO THE SENATE COMMITTEE ON FINANCE

HEARING ON "TAX REFORM: WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

Wednesday, April 25, 2012

KATHRYN WYLDE
PRESIDENT & CEO
PARTNERSHIP FOR NEW YORK CITY

Thank you, Chairman Baucus, Ranking Member Hatch and Members of the Committee for the opportunity to submit written testimony.

The Partnership for New York City is a nonprofit organization of international and regional business leaders who partner with government and other sectors to promote job creation, economic growth and public education. We strongly support H.R.1439, the Business Activity Tax Simplification Act of 2011 ("BATSA"), which was favorably reported out of the House Judiciary Committee last summer, and respectfully urge Congress to enact the bill into law this year.

Passage of BATSA has become urgent, as increasing numbers of states are facing fiscal crises and seeking to reach beyond their borders to extract revenues from the economies of other jurisdictions. BATSA would ensure that companies are subject to state business taxes only in those states where they have a physical presence and from which their business operations and employees derive benefits. It would stop the practice of taxing corporations based on where their customers, rather than their businesses, are located. This practice has resulted in significant new impositions on companies, in terms of both tax payments and compliance costs associated with responding to widely varying and constantly changing taxing schemes adopted by various jurisdictions. With approaches to taxable nexus varying from state to state, clarifying the physical presence requirement to articulate the bright-line nexus standard included in H.R. 1439 would

Co-Chairs

Vice Chairs

President and CEO

Founding Chairman

Directors

Ex-Officio Members

alleviate the burden that many interstate businesses face and help promote economic growth across the country.

New York City is a major hub for interstate commerce and many New York-headquartered companies transact business in all fifty states and around the world. New York City and State supply the infrastructure and services necessary to accommodate these companies, and tax the business community accordingly. Traditional practice in the U.S. has been that states levy business activity taxes only on those businesses that have some type of physical presence (i.e., labor force or property) in the state. We support this tradition, which is based on the premise that a business should pay tax only to those jurisdictions that have provided it with meaningful benefits and protections (e.g., public schools, roads, police and fire protection, water and sewers). Businesses receive these benefits only from the jurisdictions where they are actually located. Businesses should only pay tax where they actually earn income, and economists agree that income is earned where a business employs its labor and capital.

BATSA would provide the clarity and discipline required to maintain a rational and hospitable business environment in the United States. It will also protect the tax base of America's major commercial centers that are absorbing the costs associated with the demands of major commercial operations.

Thank you for your consideration.

Why Congress Needs to Enact Federal Sales Tax Legislation: The Devastating Impact of State-by-State "Affiliate Nexus Tax" Laws on 70,000 Small Businesses

By Rebecca Madigan
Executive Director, Performance Marketing Association

US Senate Finance Committee Hearing on: Tax Reform: What It Means for State and Local Tax and Fiscal Policy

April 25, 2012

Chairman Baucus, Ranking Member Hatch, and distinguished members of the Senate Finance Committee, thank you for the opportunity to provide testimony for your hearing examining how tax reform will impact state and local tax and fiscal policy. While the scope of this hearing is broad and the topics of debate are plentiful, on behalf of the Performance Marketing Association, I will focus my remarks on the need for Congress to enact federal sales tax legislation—specifically, S. 1832, "The Marketplace Fairness Act."

By way of background, the Performance Marketing Association (PMA) is a not-for-profit trade association founded in 2008 by the leaders of the performance marketing industry, to connect, inform and advocate on behalf of this rapidly growing field. PMA strives to raise the profile of performance marketing by demonstrating the value of this multi-billion marketing channel, which comprises more than 200,000 businesses and individuals. Continued growth of the performance marketing space is expected as advertisers, facing small budgets and big expectations, increasingly look to performance-based marketing initiatives to expand their business.

However, our industry has been seriously harmed in recent years by the efforts of several states that have passed "affiliate nexus tax laws." Indeed, state-by-state piecemeal attempts have already devastated 70,000 online-based businesses—yet yielded states $0 in new sales tax revenue and, in fact, reduced income tax revenue. A federal solution will lay to rest these desperate and futile attempts states pursue to solve their budget shortfalls.

Over the past three years, 9 states have passed 'Affiliate Nexus Tax' laws, unconstitutional attempts to compel out-of-state retailers to collect their sales tax. These Affiliate Nexus Tax (aka 'Amazon tax') laws claim out-of-state retailers have 'nexus' or physical presence, if they advertise on websites owned by businesses (known as 'Affiliate Marketers') in states where these laws have passed, thereby requiring them to collect sales tax.

These laws have been failures to the states and the impact on Affiliate Marketers has been catastrophic: out-of-state retailers simply sever their advertising agreements with Affiliate Marketers in order to avoid collecting sales tax. These affiliate marketing businesses lose a devastating portion of their income, causing them to move out-of-state, lay off employees, or shut their doors.

Real Devastation to Small Businesses

- 70,000 affiliate businesses in 8 states have been devastated by the passage of Affiliate Nexus Taxes.
- On average, these businesses lose **25% - 35%** of their income when these laws pass. *Imagine what losing a third of your income would mean to you.*
- An estimated 800-900 online retailers terminate their advertising agreements when these state laws pass.
- In California, where there were 25,000 affiliate businesses, **35% lost over half their incomes when the law passed there**. And 32% moved out of state.
- States don't gain any new sales tax revenue, and lose income tax revenue – especially when these businesses move out-of-state and take all their income with them.

Performance marketing was a $22 billion industry in 2011, the fastest growing type of advertising and one of the fastest growing technology sectors. *This industry is made up of entrepreneurs, is growing and creating a lot of jobs, except in states where the affiliate nexus tax passed.*

State-by-State Impact

Below is detail about each state where an Affiliate Nexus Tax law passed: the number of Affiliate Marketers in the states before the laws passed, their earnings and contributing state income tax revenue:

New York
Affiliate Nexus Tax passed in 2008
- 15,000 affiliate marketers
- In 2007, they earned $746 million and paid an estimated $51 million in state income tax

North Carolina
Affiliate Nexus Tax passed in 2009
- 6,000 affiliate marketers
- In 2008, they earned $416 million and paid an estimated $32 million in state income tax

Rhode Island
Affiliate Nexus Tax passed in 2009
- 800 affiliate marketers
- In 2008, they earned $57 million and paid an estimated $4 million in state income tax

Illinois
Affiliate Nexus Tax passed in 2011
- 9,500 affiliate marketers
- In 2010, they earned $744 million and paid an estimated $22 million in state income tax

Connecticut
Affiliate Nexus Tax passed in 2011
- 3,000 affiliate marketers
- In 2010, they earned $236 million and paid an estimated $7 million in state income tax

Arkansas
Affiliate Nexus Tax passed in 2011
- 2,000 affiliate marketers
- In 2010, they earned $157 million and paid an estimated $11 million in state income tax

California
Affiliate Nexus Tax passed in 2011
- 25,000 affiliate marketers
- In 2010, they earned $1.9 billion and paid an estimated $152 million in state income tax

Pennsylvania
Affiliate Nexus Tax announced (reinterpreting existing statute) December 1, 2011
- 9,000 affiliate marketers
- In 2010, they earned $700 million and paid an estimated $22 million in state income tax

Georgia
Affiliate Nexus Tax passed in March, 2012, goes into effect July, 2012
- 6,400 affiliate marketers
- In 2011, they earned over $600 million and paid an estimated $36 million in state income tax

Congress Can Help

Congress has the power to change current sales tax law, and on behalf of the more than 200,000 small businesses we represent, Affiliate Marketers, we ask the Committee to recommend legislation that will allow states to collect sales tax from out-of-state retailers, without the nexus requirement. Without the nexus requirement, the Affiliate Nexus Tax laws are moot; out-of-state retailers can reinstate their in-state advertising partnerships.

The PMA supports S. 1832 because it includes the 'No Nexus' concept, which preserves Federalism and states' unique sales tax policies – and allows Affiliate Marketers to get back in business!

In Conclusion

The PMA and our industry made up of over 200,000 small businesses nationwide, urge Committee members to recommend S. 1832.

The Performance Marketing Association (PMA) is a not-for-profit trade association founded in 2008 to connect, inform and advocate on behalf of performance marketing, a multi-billion-dollar marketing channel, which comprises more than 200,000 businesses and individuals. Continued growth of the performance marketing space is expected as advertisers, facing small budgets and big expectations, increasingly look to performance-based marketing initiatives to expand their business. Additional information is available at: http://www.performancemarketingassociation.com

WRITTEN STATEMENT OF

CAREY J. (BO) HORNE
PAST PRESIDENT

and

KATHERINE S. HORNE
PAST VICE PRESIDENT

PROHELP SYSTEMS, INC.
418 East Waterside Drive
Seneca, SC 29672

on

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

before the

UNITED STATES SENATE COMMITTEE ON FINANCE

April 25, 2012

Room 215, Dirksen Senate Office Building

Small Businesses Face an Impossible Situation

Small businesses have always faced great challenges. Today, we confront the greatest ever. Caught in the middle of an enormous struggle between large businesses and greedy states over highly complicated tax nexus issues, small businesses are left in an **impossible** position. The ability of our smallest businesses to participate in Interstate Commerce, on any basis, is **literally** at stake.

Highly aggressive, quickly expanding, and even abusive tax nexus claims made by many states amount to nothing short of legalized extortion. Except such claims are of dubious Constitutionality. The Supreme Court has said *de minimis* activity is insufficient for creating nexus. But, because such activity has not been adequately quantified into Federal law by Congress or by the Courts, the states are using every contrivance possible to defy past decisions, which are very clear to the average citizen.

The result is now leading our Nation quickly toward the very scenario which compelled our Founders to include the Commerce Clause in our Constitution. Just as occurred under the Articles of Confederation, greedy, revenue-hungry states are today seriously harming our Nation's economy. Our own personal experience clearly illustrates how real the problem is and how terribly extreme state nexus laws have become. No entrepreneur who sufficiently understands the nexus risks facing the smallest businesses today will **ever** contemplate launching a new business that depends on making interstate sales of any type or size.

The Supreme Court has declined to become further involved in this issue. Only strong action by the Congress can now prevent major damage to our fragile economy and avert **the complete closure of interstate markets to our Nation's smallest businesses. We are not the only small business which has experienced this issue. We are not even the only South Carolina small business which has been horribly burdened by it.**

Our Nation's smallest businesses cannot possibly cope with the widely varying, ever changing, and often poorly articulated nexus laws of 50 States and more than 12,000 local taxing authorities. It is unbelievable, but true, that it is today safer for small businesses to accept orders from customers in Canada than it is to accept orders from customers in other States.

We urgently ask for your support and quick enactment of a legislative solution as set forth in H.R.1439, The Business Activity Tax Simplification Act of 2011 ("BATSA"), before the problem grows even worse, more small businesses attempting to participate in Interstate Commerce are harmed, and further damage is inflicted upon our fragile economy.

The Problem is Very Severe:

In 1997, our tiny **home-based*** business, with annual sales of under $100,000, made a **one-time** sale of our proprietary software to a customer in New Jersey for $695. When it became aware of this single sale in 2003, the State of New Jersey demanded that we pay approximately $15,000 in back taxes, fees, interest, and penalties. The State further demanded that we also pay $600 in taxes and fees, **every year thereafter as long as our customer used the software, even in years when no sales are made in New Jersey, and regardless of any profit.** Since then, New Jersey has become even more punitive against businesses located elsewhere, and numerous other states have launched similar programs to export their local tax burdens.

*Located in Georgia in 1997, re-located to South Carolina in 2001.

The abuses are **not** limited to software. New Jersey and other states defy protections of the Interstate Income Tax Act of 1959 (Public Law 86-272), which prevent any state from imposing an income tax for interstate activities where no physical presence exists. Today, if one of your constituents ships a box of paper clips to a customer in New Jersey, he is exposed to similar claims.

Only after more than two years of intense effort that should have gone toward growing our business, after great legal expense had been incurred, and after our case had brought massive negative publicity to the State, did New Jersey ultimately drop its claim against our company. We received no apology or compensation for the abusive claims; and we are **still** precluded from

making sales **from our home** in South Carolina to customers in New Jersey without exposing ourselves to the same ordeal, again.

When I testified to the House Judiciary Subcommittee on Commercial and Administrative law in 2005, Congressman Delahunt immediately understood what the future holds for small businesses:

> "The case presented by Mr. Horne, I think, is an egregious example. We support you, Mr. Horne, and it's got to be addressed."

The nightmares being reported are certain to escalate. New Jersey increased its minimum tax 150% in 2002. Such taxes are effectively borne only by the smallest participants in Interstate Commerce. The victims are generally not capable of fighting, they capitulate to reduce the risk of larger penalties, and they have absolutely no representation in the matter **except right here in the Congress**.

Without clear protections such as "BATSA" provides, aggressive states will always seek to stretch the limits and to impose their own creative definitions to justify taxation most citizens would consider unjust. Similar business activity taxes have already spread to Michigan, Ohio, Texas, and many other states. Can anyone believe they will not soon be implemented by **all** states? **Every state**, even those who understand the damage being done, will be **forced** to implement similar taxes for **retaliatory** reasons. Each state will be **forced** to recoup its own legitimate tax revenues siphoned off by the more aggressive states acting before them. **The inevitable result will be the complete closure of interstate markets to our Nation's smallest businesses, and further damage to our National economy.**

The Impossible Situation:

As documented by numerous large businesses, including Smithfield Foods during the 2004 "BATSA" hearing in the House Judiciary Committee, the burden of complying with so many widely varying tax laws is enormous. **Small** businesses find actual compliance to be **impossible** and even the **expectation** of compliance to be **completely unreasonable**. For these reasons, the Supreme Court has declared such claims against small businesses to be unconstitutional, in multiple major decisions such as Complete Auto Transit.

As indicated earlier, though, the states simply ignore the **total impossibility** for any small business to:

• Become familiar with the widely varying and ever changing nexus and tax laws of 50 States, let alone comply with them. How will mom and pop businesses **ever** be able to comply?

• Deal with the staggering burden of 12,000 differing nexus laws and business activity taxes authorized by the states for their localities. How can **any** small business handle such magnitude?

• Cope with the staggering variety of minor yet very common business activities that subject them to abusive assertions of interstate nexus.

• Devote the administrative resources necessary to keep business activity records for 50 states and 12,000 localities. Why should we even have to try?

• Find funding for the preparation of **totally different** tax returns for up to 50 states and 12,000 localities. How could **any** government unit even expect us to attempt this?

• Pay $30,000 per year, or even more, every year, **forever**, in minimum business activity taxes and fees, **even if no sales are made anywhere**. This will be the result for **every** small business, regardless of sales or profits, when all 50 states adopt New Jersey's Corporate Business Tax and a single *de minimis* sale has been made, in some prior year, in every state. It will be even worse when localities are included. Much history, past and current, has proven such abusive claims against our Nation's small businesses **will occur** unless Congress acts decisively to protect us.

• Once confronted with an abusive claim, find an affordable attorney who is knowledgeable about interstate nexus issues. When faced with the issue in 2003, calls to every attorney in Atlanta and throughout South Carolina specializing in tax or computer law led to **no one** familiar with our problem. Of course, we did not call the largest downtown firms, because we **knew** we could not afford them. Ultimately, the South Carolina Department of Revenue led us to perhaps the only attorney in South Carolina familiar with interstate nexus issues. He told us, up front, that we could not afford him, but thankfully gave us a lot of very useful advice, pro bono.

• Meet strictly enforced time limits imposed by states for contesting aggressive and even unconstitutional claims. The logistics of finding adequate and affordable representation for a highly complicated issue in a state far away are **insurmountable** for most small businesses.

• Defend itself against an aggressive, far away state. Many of the claims made against small businesses are clearly unconstitutional, on multiple grounds. States are now regularly asserting claims for only *de minimis* activity in the state. They continue to pursue aggressively even the weakest cases because they know it is **virtually impossible** for small businesses to fight back.

• Finance the defense of an egregious claim all the way to the Supreme Court. The states are taking maximum advantage of a system that requires all tax cases, including those where substantial constitutional issues are involved, to exhaust all legal remedies within the state first. At that point, the only recourse is to the United States Supreme Court. Few, if any, small businesses will find this arduous route anything but **utterly impossible**.

Our Experience is *Not* an Isolated Case:

Our many conversations with people across the country show that abuses are far more common than generally recognized. At the time of my testimony before the House Judiciary Committee in 2005, we were already personally aware of approximately fifteen small business victims located in multiple states.

We did not search for these victims. Desperate for help, **they found us**, from testimony we submitted for the 2004 hearing or from numerous magazine and newspaper articles written about our case. Since the 2005 House Judiciary Committee hearing, approximately fifteen **more** businesses have sought us out, also desperate for any help they can find for dealing with their crisis. One of the calls was from a small trade organization representing seafood processors; approximately twenty of their members in the Delmarva area had been trapped. When a tiny, **home-based** business learns of almost **fifty** small companies across the country faced with nexus nightmares, the true extent of the problem must be **enormous**.

We are completely flabbergasted that almost a dozen attorneys from across the country also have called us, trying desperately to learn as much as they can as quickly as they can, in order to provide adequate representation for their local clients fighting battles with far away states.

Each of the Finance Committee members should clearly understand that small businesses in your own States are **already** being wrongly burdened by greedy states, because we lack the vital protections every small business **assumes** already exist.

The Solution:

Some small businesses are not yet vocal with their support for a federal legislative solution, like "BATSA". They are generally totally unaware that numerous far away states are now taxing sales they implicitly assume are protected. Most are unaware that states are also now regularly ignoring or circumventing the basic protections granted by the Interstate Income Tax Act of 1959 (PL 86-272).

Most have no idea what nexus is, and don't really want to know. They just want to grow their businesses and help expand the Nation's economy. They have no idea that the sales they are regularly making across state lines, through a physical presence in their home state only, are exposing them to the same nexus nightmares many other small businesses have already encountered.

As the states employ more powerful and more pervasive systems to track the smallest sale made anywhere, small businesses will be regularly trapped like a deer in headlights, totally defenseless against what will soon occur, unless Congress uses its broad authority to protect the right of every small business to participate in Interstate Commerce on a reasonably unfettered basis.

Our personal experience, plus those of other small businessmen testifying to the House Small Business Committee on February 14, 2008, clearly show what happens when the standard leaves the smallest avenue open to abuse by greedy States. **Without strong Federal legislation, small businesses will soon be unable to participate in Interstate Commerce, on any basis.**

The arguments about state sovereignty and how we must change our tax systems to accommodate the Internet economy are not reasonable for this debate. Small businesses have their backs to the wall. They now face the very situation that caused the Founders to give **you**, the Congress, the power to regulate Interstate Commerce. You **must** now use that power to protect our small businesses and even the entire National economy.

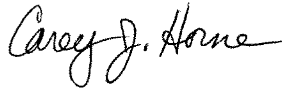
Only a **strong** restatement of the fundamental principles of physical presence will resolve the tragic and **impossible** consequences small businesses are facing. These principles worked so well for more than 200 years that they were simply "understood" and not even codified into law until the Congress did so with the Interstate Income Tax Act of 1959.

It is now **urgent** that this Congress modernize that Act quickly to protect our small businesses and our National economy. The Act must be expanded to cover all types of sales, both products and services, and it must prohibit all types of business activity taxes which are so harmful to the smallest of businesses.

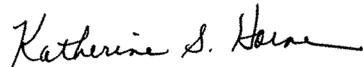
Having faced this issue, up close and personal, for almost eight years, we know the Business Activity Tax Simplification Act is **exactly** what small businesses need. We urge the Senate Finance Committee to use its full resources to insure prompt enactment of such legislation. Only then can our Nation's small businesses safely redirect their full energies to growing our economy instead of defending themselves against egregious claims of nexus made by a rapidly growing number of states.

Many of the points made in this document also apply to every bill now being considered for setting National standards for the collection of State sales taxes. **We urge the Finance Committee to insure, in any bill moved forward, the Nation's smallest businesses receive absolute protections from the inevitable administrative burdens which will be created.**

Our economy is in great peril. Our Nation cannot afford to allow nexus abuses to damage it further.



Carey J. Horne
Past President



Katherine S. Horne
Past Vice President

ProHelp Systems, Inc.*

* ProHelp Systems, Inc. was a Georgia Corporation, chartered in 1984. It was dissolved in 2007 because of our inability to deal with the complexity of the interstate tax and nexus issues we faced.

TESTIMONY OF PULTEGROUP, INC.

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BLOOMFIELD HILLS, MI483204

BEFORE THE

UNITED STATES SENATE COMMITTEE ON FINANCE

APRIL 25, 2012

Chairman Baucus, Ranking Member Hatch and Members of the Committee, thank you for holding a hearing on *Tax Reform: What It Means for State and Local Tax and Fiscal Policy*. PulteGroup, Inc. would like to direct your attention to a state tax issue of great importance to our company and thousands of other businesses that operate in interstate commerce: business activity tax nexus. The issue relates to the circumstances in which a state properly may assess income and similar taxes against non-resident companies. To resolve the issue, we urge immediate enactment of federal legislation, as set forth in H.R. 1439, the Business Activity Tax Simplification Act ("BATSA").

PulteGroup, a Michigan corporation, is one of the largest homebuilders in the United States. While our Company primarily engages in the homebuilding business, we also have mortgage banking operations and title operations. Our core business includes the acquisition and development of land primarily for residential purposes within the United States and the construction of housing on such land. We conduct our operations in approximately 61 markets located throughout 29 states. Over our history, we have delivered nearly 600,000 homes.

Business activity tax nexus is the most important issue affecting interstate commerce and the growth of the U.S. economy. Resolution of the problem by enactment of federal legislation is a priority for PulteGroup; indeed it is a requirement for the company's future growth and success.

Traditionally, the states and the courts accepted the historic principle that a business must have a "physical presence" in a state before that state may assess income and similar taxes. More recently, some states have abandoned the traditional physical presence nexus standard and have attempted to assert a right to tax non-resident businesses based on "economic nexus," or the mere presence of customers, absent any physical presence in the taxing jurisdiction. Our Company has been subjected to such attempts by states to expand their right to tax based on "economic nexus" increasing our cost of doing business during a time when we can least afford it. Further, the continued expansion of these attempts by more states creates great uncertainty for Companies such as ours as we consider possible expansion of our business.

Such efforts by states to unconstitutionally expand their taxing authority have led to unfairness and uncertainty, increased compliance costs, hindered business expansion and put companies at risk of duplicative over-taxation.

BATSA, which was reported out of the House Judiciary Committee by voice vote last year and which enjoys bipartisan support, would prevent unlawful impediments to the free flow of commerce among the states by clarifying that no state may impose a business activity tax on any entity that lacks a physical presence in the taxing jurisdiction. The bill would provide a bright-line definition of physical presence. In addition, the Act would modernize current law (Pub. L. 86-272) relating to state authority to impose net income taxes on certain income derived from interstate commerce, to cover services and intangible property. Thus, businesses would continue to pay business activity taxes to those jurisdictions that provide them with meaningful benefits and protections. To be clear, we at PulteGroup do not seek to pay less tax in states where we have a physical presence, we simply desire clarity and consistency as we serve customers on a multi-state basis.

The enactment of BATSA would contribute to the type of stable business climate that encourages increased business investment, expanded interstate commerce and a healthy American economy.

Thank you for your time and attention to this important issue.

Statement for the Record

Senate Finance Committee

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

215 Dirksen Senate Office Building

Katherine Lugar

Executive Vice President of Public Affairs

Retail Industry Leaders Association

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E-Fairness:
It's all about Equal Treatment, Jobs and States' Rights

On behalf of the Retail Industry Leaders Association (RILA), thank you for holding this hearing entitled "Tax Reform: What It Means for State and Local Tax and Fiscal Policy," and for providing your colleagues and the public with the opportunity to discuss tax reform issues related to state and local finances. State and local governments are closely studying what implications tax reform will have for them, as is the retail industry, but one issue that does not have to wait for comprehensive tax reform is the fair treatment of all retailers with respect to sales tax collection.

By way of background, RILA is the trade association of the world's largest and most innovative retail companies. RILA promotes consumer choice and economic freedom through public policy and industry operational excellence. Its members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than $1.5 trillion in annual sales, millions of American jobs and more than 100,000 stores, manufacturing facilities and distribution centers domestically and abroad.

A sale is a sale is a sale. Whether it takes place online or at a local business, the same rules should apply online as they do on Main Street. Common sense would dictate that if a product is purchased online, the retailer should collect and remit sales tax, just as is the case when a customer goes to the store in person.

Due to a decades-old loophole that pre-dates the internet (the result of the 1992 *Quill* Supreme Court decision), online-only companies can achieve as much as a 10 percent price advantage over brick and mortar retailers by refusing to collect and remit the state and local sales tax owed on purchases made online. This special treatment has the effect of the government picking winners and losers in the marketplace, and local businesses simply cannot compete over the long-term with online giants that exploit this government-sponsored loophole.

For RILA, as well as millions of Main Street brick and mortar businesses, the top priority for the industry is to level the playing field on the collection of sales taxes between brick and mortar retailers and remote sellers. A wide spectrum of states – California, Texas, Illinois, Pennsylvania, Virginia, Georgia, Tennessee, Indiana, and just this week Nevada – have already either passed state legislation or taken administrative action to partially level the playing field. But Congress must still act.

Because of the constitutional issues in the *Quill* decision associated with the Commerce Clause, states cannot completely level the playing field on their own: federal legislation

is required. In fact, in its decision in *Quill,* the Supreme Court invited Congress to exercise its authority to solve this problem and let the states enforce their laws to level the playing field. Writing for the majority, Justice John Paul Stevens wrote, "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."

On November 30, 2011, the House Judiciary Committee held an oversight hearing entitled "Constitutional Limitations on States' Authority to Collect Sales Taxes in E-Commerce" where the National Governors Association endorsed bipartisan federal legislation, such as S. 1832 (The Marketplace Fairness Act), introduced by Senators Mike Enzi, Richard Durbin, and Lamar Alexander, to remedy this inequity. S. 1832, and a similar House bill (H.R. 3179, The Marketplace Equity Act), provide states with the tools to apply equal treatment of the collection of sales taxes on remote sellers, while minimizing administrative burdens and costs for remote sellers to collect and comply.

Unless the current system is corrected, local retailers – big and small – will increasingly be forced to close their doors, taking with them the millions of retail jobs they provide, as these businesses are punished by the government for following the law, while their online competitors are exempt. From local booksellers and jewelers to national chains, the tilted playing field has already cost thousands of local jobs and more are threatened the longer this disparity continues. These businesses provide crucially needed jobs, pay local property taxes and make critical civic investments in our communities. Punishing local businesses in favor of out of state business runs counter to the government's efforts to building local communities that are vibrant and healthy.

Further, this is a matter of states' rights. A state should be able to enforce their laws regardless of whether a product or service is purchased from an in-state or out-of-state vendor. Congress should allow the state to enforce their own laws, taking the government out of business of picking winners and losers.

States can also choose to lower other taxes with e-fairness collections. At a time when nearly every state is facing significant budget shortfalls, states are considering increasing sales and property taxes to close these gaps, which have the effect of further widening the disparity between brick and mortar stores and remote vendors. According to the National Conference of State Legislatures, over $23 billion dollars in sales taxes will go uncollected this year alone even though consumers still owe a corresponding use tax. As the Internet continues growing as a retail platform, this collection gap will only grow larger.

It should be noted that closing this loophole cannot be construed as a new tax. Just because some online-sellers don't currently collect the tax doesn't mean the state's sales tax is not still due. In fact, today online-only establishments are leaving individuals who purchase items on their Web sites exposed since these consumers are still legally responsible for paying the tax directly to the state. In addition, advances in tax software,

already available, as well as the simplification requirements in S. 1832 – a small seller exemption, uniform rates and tax base in a states, and centralized filing and remittance - allow Congress to address this issue without burdening interstate commerce.

In closing, RILA appreciates the opportunity to submit this written testimony for the record. Congress can and should immediately pass e-fairness legislation in order to ensure a level playing field that protects jobs on Main Street, and reduces budgetary pressure on states to further increase sales and property taxes. A comprehensive federal approach should allow the state, individually or through an interstate compact, to simplify their sales tax laws. This solution would simply provide self-help for the states, and it would do so without adding a penny to the federal deficit. Bipartisan bills such as, S. 1832, in the Senate, and H.R. 3179, in the House, can solve this problem and put home town businesses on a level playing field with online only sellers, and there is no reason why we should wait until tax reform to move forward with these common-sense solutions.

Written Testimony by

Sears Holdings Corporation
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Committee on Finance
United States Senate

Hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

On behalf of the 264,000 employees of Sears Holdings Corporation, we thank the Committee for holding this important hearing on tax reform as it relates to state and local governments and most specifically, the "Marketplace Fairness Act" (S. 1832). Sears Holdings strongly supports this bipartisan legislation that aims to cure a long-standing inequity between brick and mortar and online-only retailers by giving the states the ability to enforce existing laws and require remote sellers to collect and remit sales taxes on purchases to its residents.

Sears Holdings Corporation (Sears Holdings) is the parent company of Sears, Roebuck and Co., Kmart, and Lands' End. We are one of the nation's largest broadline retailers with approximately 3,500 full-line and specialty retail stores in the United States.

This legislation, and similar legislation in the House (the "Marketplace Equity Act" H.R. 3179), will restore balance and fairness to the system by enabling states, ***if they so choose***, to enforce the collection of taxes that are already owed by every customer making a purchase, whether the purchase is online or in a retail store.

Over the years, some have – intentionally and unintentionally – misrepresented the issue as a "new tax". This is not a new tax, although, unfortunately, most customers don't realize that they have the obligation to pay these taxes if they are not collected by the merchant. This legislation simply eliminates the need for customers to file and pay use taxes or to calculate and include the tax owed on their income tax return. Instead, states will be allowed to require online-only sellers to collect the tax at the point of sale just as they do with retailers who have a physical presence in the state. State sovereignty is a key tenet in taxation matters and it is important to point out that this legislation would in no way mandate the states do anything. Each state has the right to choose to enforce its laws.

Many states are grappling with unprecedented budget deficits and they too are passing various versions of bipartisan legislation to close this loophole that has given a significant competitive advantage to a handful of online-only retailers, while hurting those that create jobs and invest in local communities.

Ultimately, only Congress has the authority, and we would argue – a duty, to act on this important interstate commerce issue. In fact, the 1992 ***Quill Corp. vs. North Dakota*** decision made this very clear.

Sears Holdings urges Congress to act quickly and pass this bipartisan legislation this session to address an issue that has resulted in over a decade of unfair competition between retailers who collect the sales tax and those who refuse to do so. The Marketplace Fairness Act levels the playing field between brick and mortar and online-only retailers, helps state and local governments, and does this all without costing the federal government a dime.

We thank the Committee for examining this important issue.

Invested in America

Statement of the Securities Industry and Financial Markets Association
Submitted to the United States Senate Committee on Finance
Full Committee Hearing

"Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

April 25, 2012

The Securities Industry and Financial Markets Association[1] supports the *Business Activity Tax Simplification Act* (BATSA) co-sponsored on a bipartisan basis by two members of this Committee in the 110th Congress and now pending in the House. This important legislation would establish clear rules for determining state tax jurisdiction. It would not reduce the revenue pie, nor would it necessarily reduce the amount of tax paid, but it would assure that our members' income is taxed solely in the states where they do business. It would do so by establishing an easily administered and understood physical presence threshold for business activity taxation. This simple exercise of Congress's power under the Commerce Clause would reduce costly state tax litigation, uncertainty, and the prospect of multiple taxation.

In 1992, the U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that a state could not require an out-of-state business to collect sales and use tax unless that business has a physical presence within the taxing state. At that time, the Supreme Court declined to specify the threshold that would trigger business activity taxes. Many tax experts argued that the physical presence standard should apply here as well. Unfortunately, over time, certain states have devised creative new legal theories on business tax nexus to claim an ever expanding share of interstate income, leading to costly litigation and uncertainty for business taxpayers and stimulating an unhealthy competition among the states to claim revenue share.

BATSA would sharply diminish confusion and the potential for multiple taxation that exists now because of absence of clear rules on business activity tax nexus. This is particularly important to the financial services industry, because some jurisdictions have sought to impose business activity taxes on companies that have no physical presence in the state but that increasingly serve customers remotely through mail and the internet.

It would not be unprecedented for Congress to act to protect interstate commerce by mediating a difference among states about how to divide the taxable income of multistate businesses. In 1959, when a Democratic majority of the U.S. House and Senate sent P.L. 86-272 to the desk of President Eisenhower, Congress was motivated by the same desire to establish clear and administrable rules to allow the expansion of interstate commerce. Senator Harry F. Byrd of Virginia, then Chairman of this Committee

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

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and a former governor himself, worried that states would "further encroach upon interstate commerce" if Congress failed to act.

Far from devastating state revenues as today's critics claim, the enactment of P.L. 86-272 paved the way for an historic expansion of interstate sales of goods that benefited the states collectively and individually. Consumers have benefited greatly as well from the creation of a national market for the sale of goods. Static models of state revenue of the type generated by the Congressional Budget Office are incapable of capturing the demonstrable benefits of a stable tax and legal environment for interstate commerce, and, unfortunately, the benefits of the 1959 law have waned as our economy has shifted from a goods to a service economy. BATSA wisely expands this foundational law to cover non-physical products.

By establishing clear and consistent bright-line standards, BATSA will help to create jobs and revive our economy by providing certainty in interstate commerce to both businesses and to state and local governments. SIFMA urges the Senate Finance Committee to act on this important legislation.

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Testimony
by
Vernon T. Turner

Vice President, Corporate Tax
Smithfield Foods, Inc.
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Smithfield, Virginia 23430

Hearing on Tax Reform: What It Means for State and Local Tax and Fiscal Policy

Before the United States Senate Committee on Finance

The Honorable Max Baucus, Chairman

April 25, 2012

Mr. Chairman and Members of the Committee,

On behalf of Smithfield Foods, Inc, I respectfully submit the below testimony for the record. My name is Vernon T. Turner, and I am Vice President, Corporate Tax for Smithfield Foods, Inc. I last testified before the Committee on the Judiciary, Subcommittee on Courts, Commercial and Administrative Law, in 2004. In my testimony, I stated that current state interpretation of the business activity tax was doing a substantial amount of damage to the American business community and to companies like Smithfield Foods. Since that time, the state tax landscape has gotten significantly more complex, and the various state tax authorities are far more aggressive. It is our hope that the Business Activity Tax Simplification Act of 2011 can ameliorate this situation.

I. Introduction

- Background on Smithfield Foods

Smithfield Foods, Inc. is the world's largest pork processor and hog producer, headquartered in Smithfield, Virginia. We have worldwide sales of over $12.2 billion, and are a "Fortune 500" company. Our company has experienced remarkable growth from its early origins as a small pork processor. Today, we are a worldwide company, with sales in all fifty states. Our various subsidiaries have physical operations in approximately thirty-five states.

- Why Smithfield is Testifying

We incur substantial costs to meet our state tax obligations. On an annual basis, we are required to file 1,100 state income tax returns, 400 sales and use tax returns, 2,600 state payroll tax returns and 1,100 real and personal property tax returns. This results in

various state payments of approximately $140 million. In spite of our efforts to comply with laws with all the states, we continue to find state interpretation of the business activity tax to be difficult and troublesome.

II. The Problem — Bureaucratic Arbitrariness

The U.S. Supreme Court and Congress have decided that states may not unduly burden companies that have no physical presence in a state with "business activity taxes."

In 1992, the U.S. Supreme Court held in Quill Corporation v. North Dakota that the U.S. Constitution requires a bright line physical presence rule for the imposition of use tax collection responsibility. Many scholars and state tax experts believe that the Quill standard applies to all state taxes, not just use tax.

Public Law 86-272, still good law, was enacted by the U.S. Congress to provide a similar bright line standard. It bars states from imposing a net income tax on companies whose only in-state activity is the solicitation of sales of tangible personal property.

Despite the decision of the U.S. Supreme Court and Congress, states continue to attempt to tax companies regardless of physical presence. States have, for example, enacted and imposed gross receipts taxes, net worth taxes and fixed dollar minimum taxes on out of state companies under the theory that Public Law 86-272 bars imposition of only net income tax. States have argued too, that Quill applies only to use tax. As a result, businesses struggle with multistate tax compliance in the face of conflicting and confusing guidance. This situation needs to be clarified, and BATSA seeks to do that and not more.

III. BATSA

Interstate sales are today more the rule than the exception, not only for large corporations like Smithfield, but small and medium sized enterprises as well. The current state of confusing and arbitrary taxation of multi-state companies that are selling product across state lines only serves to chill interstate commerce. BATSA will eliminate confusion and the need for companies to engage in protracted and costly litigation as the way of ameliorating discrepancies in tax enforcement. BATSA does not diminish the ability of states to collect tax revenue. It rationalizes and makes more predictable the process of doing so.

IV. A Smithfield Experience with State Tax Law

We experienced a prime example of the arbitrary and confusing application of state income tax laws. This example is not a gross exception. In fact, it is just a metaphor of a larger problem. A collection agent with the New Jersey Department of Taxation stopped one of our trucks, loaded with refrigerated product, on the New Jersey turnpike. The agent held the truck and its driver for several hours, and demanded that, in order to release the truck, Smithfield had to wire $150,000 immediately to the New Jersey

Department of Taxation. The agent claimed that he had the right to hold the truck and its contents because we had failed to properly file New Jersey tax returns.

I informed the Jersey agent that his claim was unfounded. I explained that Public Law 86-272 protected our subsidiary from New Jersey income taxation since it only engaged in mere solicitation in New Jersey and had no physical operations in the State. The agent refused to accept this explanation. However, he finally agreed to release the truck and its driver in return for $8,000.

We appealed this aggressive and incorrect application of Public Law 86-272 to the New Jersey State tax commissioner. Ultimately, New Jersey accepted our contention that we have no physical presence in the State and are not subject to New Jersey income tax. They issued a refund and an apology for their roadside justice system.

Our experience is not unique; it is shared by many businesses, large and small. Many small companies do not have the ability to make an immediate wire transfer of funds much less obtain ultimate recourse from aggressive states. We believe that BATSA will clarify the physical presence standard embodied in Public Law 86-272 and the Quill decision. This is sound public policy and we urge its passage.

April 29, 2012

To:	Senate Committee on Finance Attn. Editorial and Document Section Rm. Sd-219 Dirksen Senate Office Bldg. Washington, DC 20510-6200	Cc:	Mr. David Grogan Senior Public Policy Analyst American Booksellers Association 200 White Plains Road Tarrytown, NY 10591
From:	The Soccer Dealers Association Attn. Jonathan Hayden PO Box 556 Kenwood, CA 95452	Cc:	Mr. Scott Peterson Executive Director Streamlined Sales Tax Governing Board 4205 Hillsboro Pike, Suite 305 Nashville, TN 37215

RE: Internet Sales Tax Legislation

The Soccer Dealers Association (SDA) was founded in 2010 to organize, represent and serve the interests of the independent soccer dealers of North America. Independent soccer dealers are not only retailers but also team dealers. Many also have active Internet websites for reselling product.

The SDA supports the efforts and legislation both nationally and locally (state based) to enact a sales tax obligation on any Internet sale coming into our marketplace. Main Street businesses such as ours are critical to ensuring the long term economic stability of the local marketplace and communities.

Obviously all retailers are negatively impacted by the current lack of taxation on Internet sales. What differentiates the soccer dealer from most retailers is the team sales aspect of our business. We sell small to large clubs. Many of these youth organizations are "for profit" and therefore are subject to sales tax if they purchase their requirements locally. Unfortunately many of these clubs have chosen not to source their needs locally because of the sales tax cost to do so. In the state of Illinois for example, if a "for profit" club purchases product locally they may be subject to as much as a 10% sales tax rate. It is not unusual for club purchases to exceed $100,000 annually. Given this scenario the club would have to pay the retailer $10,000; and the state, community and business all benefit. The reality is that this club is often times buying from outside the state to avoid the sales tax obligation. Now who benefits? Not the state, community or business. This occurrence is happening all too often and costing everyone much needed revenue.

Companies like Amazon and Overstock are mentioned regularly in the ongoing dialog of taxation because their impact affects a diverse set of industries and brick and mortar businesses, large and small. The "Amazon" in our industry is Sports Endeavors (sportsendeavors.com) DBA Euro Sport (soccer.com). This company resides in Hillsborough, North Carolina, but has no physical locations outside of its corporate location. Euro Sport does not charge nor do they collect taxes in 49 states. This Internet based business negatively impacts every soccer specialty business in the country, not because they are price aggressively, but because they do not charge sales tax, except in North Carolina.

Euro Sport is a well run business, but so too are the soccer specialty dealers throughout the United States. Why is Euro Sport, or any Internet operator, given an unfair competitive advantage versus local business, in a country where every state has severe financial issues? Was this the intent of the ruling created in the Internet Tax Freedom Act of 1998? Is a ruling which originated 14 years ago, still relevant today? The SDA believes the answer is a resounding no!

Please level the playing field for all brick and mortar - Main Street businesses and vote in favor of the Marketplace Fairness Act. Give the states the right to tax and collect the much needed revenue on Internet sales and at the same time allow local businesses to survive and contribute to their state and local communities.

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

HEARING ON TAX REFORM:

WHAT IT MEANS FOR STATE AND LOCAL TAX AND FISCAL POLICY

APRIL 25, 2012

STATEMENT FOR THE RECORD

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The Software Finance and Tax Executives Council (SoFTEC) thanks the Chairman and Ranking Member for the opportunity to submit this statement for the record on the Committee's hearing on "Tax Reform: What It Means for State and Local Tax and Fiscal Policy." SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting.

SoFTEC's members are primarily interested in three issues that come within the scope of the Committee's hearing:

(1) Simplification of state sales and use taxes as a prerequisite to mandatory collection of such taxes by interstate sellers,

(2) Codification of a physical presence "nexus" standard for state business activity taxes and

(3) Standardization of state sales and use tax rules applicable to sales of electronically delivered products and services.

Many SoFTEC members provide their products and services to customers in multiple states. Many states, for state income and other business activity taxes purposes, use the Internal Revenue Code definition taxable income as the starting point for determining the amount of the state taxes on net income. Changes to the tax base for federal income tax purposes as a result of tax reform are likely to cause changes to the tax base for state tax purposes which, in turn, likely will trigger state examination of all of their sources of revenue, including sales and use taxes. Thus, SoFTEC has an interest in providing the Committee with its perspective on the impact federal tax reform might have on the three state tax issues outlined above. We will discuss each in turn.

1. Simplification of State Sales and Use Taxes as a Prerequisite to Mandatory Collection of Such Taxes by Interstate Sellers.

Current rules require that an out-of-state seller have "nexus" with a state before that state can require the seller to collect and remit taxes imposed on the sale of goods and services to customers in the state.

"Nexus" generally is the jurisdictional predicate that must exist before a state is permitted to exert its taxing power over a nonresident taxpayer and is of constitutional dimension, finding its roots in the Due Process and Commerce Clauses. The Supreme Court, in its most recent "nexus" decision described Due Process "nexus" as follows:

> The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill v. North Dakota,* 504 U.S. 298, 306 (1992), quoting *Miller Bros. Co. v. Maryland,* 347 U.S. 340, 344-345 (1954).

The Court in *Quill*, in discussing the Commerce Clause aspect of "nexus," went on to note that the Commerce Clause requires "a substantial nexus and a relationship between the tax and State provided services," which "limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." *Id* at 313.

Thus, in order for a state to assert its taxing authority over an out-of-state taxpayer, such taxpayer must have a "substantial nexus" with the taxing state. This is where the clarity ends and the uncertainty begins, since the question of when and whether a taxpayer's "nexus" or connection with the taxing state is "substantial" is almost always a question that turns on the facts and circumstances of each individual case.

In the case of sales and use taxes, we know that the "substantial nexus" requirement is met when the taxpayer has a "physical presence" in the taxing state. See *Quill, supra.* However, there are disputes between taxpayers and tax administrators over whether a taxpayer's physical presence is *de minimis* and not sufficient to trigger a tax compliance obligation, or substantial enough to require the collection of sales and use taxes from customers. See e.g., *Amazon.com LLC v. New York State Dept. of Taxation and Finance*, 2010 NY Slip Op 07823 (81 AD3d 183) (Nov. 4, 2010).

There is no question that Congress has a role to play in bringing clarity to the definition of "nexus." First, the Supreme Court has noted that Congress is best suited to resolve these issues:

> 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, [n.10] 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.
>
> *Id* at 318.

The Supreme Court thus has made it clear that Congress, pursuant to its power under the Commerce Clause, is the ultimate arbiter when it comes to defining the contours of the interstate taxing powers of the states. Indeed, the above quote from the *Quill* decision seems almost an invitation for Congress to exercise such power. The fact that the Court has not spoken on the issue of "nexus" in the 20 years since it issued the *Quill* decision suggests that the Court is disinclined to offer much needed guidance with respect to these issues.

In deciding to retain the "physical presence" "nexus" standard, the Supreme Court in Quill noted with significance the burdens that would be visited on interstate seller by the obligations of collecting and remitting sales and use taxes for 6,000 taxing jurisdictions with their associated many variations in rates of tax, in allowable exemptions and administrative and record keeping requirements. Not much has changed in the sales and use tax complexity landscape in the 20 years since *Quill* was decided. While some progress has been made in the area of simplifying administrative and record keeping requirements, nothing has been done with regard to the proliferation of tax rates. As the witness from the Tax Foundation testified, the

number of taxing jurisdictions is up to 9,600, with 400 new taxing jurisdictions added in the last year alone.

There are proposals pending in the Senate that would overturn the physical presence standard of *Quill* and permit states to require that sellers with no physical presence in the state collect and remit taxes on sales to customers in their state. See Main Street Fairness Act, S. 1542, Marketplace Fairness Act, S. 1832. SoFTEC believes that, before it lifts the physical presence nexus standard of *Quill*, Congress should require the states to undertake "radical" simplification of their sales and use taxes. SoFTEC further believes that the simplification required of the two bills pending in the Senate is not the sort of "radical" simplification that would justify lifting the physical presence standard and for this reason does not support them.

By "radical" simplification, we mean something must be done to make sure remote sellers are not exposed to the burden that would be visited on them by having to keep track of the 9,600 (and rising) taxing jurisdictions. We have a proposal: one rate per state for all remote sales (both interstate and intrastate). Under our proposal, the number of taxing jurisdictions remote sellers would be exposed to would be reduced from 9,600 to 46 (including DC, 5 states have no sales tax). In addition, states would be permitted to retain all of their 9,600 taxing jurisdictions for local, over the counter, sales. We believe this proposal would represent the sort of "radical" simplification that would justify lifting the physical presence nexus standard.

SoFTEC also believes any legislation lifting the physical presence nexus standard for sales and use tax collection purposes should include provisions codifying it for purposes of state taxes on income and other business activity, an issue we address below.

2. Codification of a Physical Presence "Nexus" Standard for State Business Activity Taxes.

Whether the physical presence "nexus" standard applied by the Court in *Quill* to sales and use tax collection obligations extends to other types of taxes, such as income or other business activity taxes, is the subject of much litigation. See, e.g., *Geoffrey v. South Carolina Tax Commission,* 313 S.C. 15 (1993) (physical presence test of *Quill* does not apply to state income taxes); *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999) (physical presence required for imposition of corporate net income taxes).

Thus, depending on the state, physical presence may or may not be the nexus standard for determining when an out of state taxpayer has an obligation to pay a state's business activity tax. Since the Court's 1992 decision in *Quill,* the Court has not clarified the "nexus" requirement for imposition of state taxes on interstate commerce; the Court declined to take any of the several petitions for certiorari that raised the issue.

Additionally, attempts by some states to impose a business activity tax on a non-resident business that has no physical presence is out-of-step with international tax treaty norms that even permit foreign firms a limited amount of physical presence before they will subject it to local taxes. See Model Tax Convention on Income and Capital, Organization for Economic Co-Operation and Development. Thus, a foreign firm with no physical presence in a state could be subject to state taxes but, because the federal government has a tax treaty with the firm's host

country having a different jurisdictional standard, the firm would not be subject to federal income taxes. There is no sound policy basis for this disconnect and no reason why the states should be allowed to be so out-of-step with international tax norms.

Additionally, the Congress previously used its power under the Commerce Clause to provide some guidance for interstate taxpayers. In 1959, in response to the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U. S. 450 (1959), Congress enacted P.L. 86-272 prohibiting states from imposing net income taxes on out-of-state taxpayers whose only contacts with a state were the solicitation by employees or representatives of a seller of orders for sales of tangible personal property where the orders were sent out of the state for acceptance and were fulfilled by shipment or delivery from a point outside the state. See 15 U.S.C. Sec. 381.

The problem with P.L. 86-272 is its 1959 vintage. P.L. 86-272 does not encompass the myriad interstate business practices which have grown up since the enactment. Because it is limited to sales of tangible personal property, P.L. 86-272 may not apply to licenses of software nor sales of electronically delivered services, business models that did not exist in 1959. Nor does P.L. 86-272 encompass other types of state taxes, such as gross receipts taxes, which were not in favor at the time of its enactment and which states have since imposed in order to circumvent P.L. 86-272's protections.

States are becoming increasing aggressive in pursuing out-of-state companies with no physical presence in the taxing state for state income or other business activity taxes. These companies with no physical presence consume no state resources for which they ought to compensate. These states seek to export their tax burden to taxpayers who play no role in the political life of the state.

3. **Standardization of State Sales and Use Tax Rules Applicable To Sales of Electronically Delivered Products and Services.**

Another set of problems Congress is uniquely situated to address are those associated with state and local sales taxes imposed on sales of electronically delivered products and services. Examples of electronically delivered products include downloaded movies, music, books and software. Examples of electronically delivered services include internet based data storage services, tax return preparation services, and internet access to websites offering software functionality as a service.

One problem associated with application of the sales and use tax rules to electronically delivered products and services is determining whether a state has the power to tax the sale. As noted above:

> The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill v. North Dakota,* 504 U.S. 298, 306 (1992), quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954).

The question here is whether there is sufficient connection between the state and the transaction it seeks to tax. The Supreme Court, in a case involving sales and use taxation of interstate telephone calls (which are similar to the electronic delivery of digital products and services), held the only two states that have a nexus substantial enough to tax interstate phone calls are the states in (1) which the call either originates or terminates and (2) which has either the service address or the billing location. See *Goldberg v. Sweet,* 488 U.S. 252, 263 (1989).

Applying the rationale of *Goldberg* to sales of electronically delivered products and services, it is not clear any state has sufficient connection to such sales to impose a sales or use tax. Seldom does the seller have any information regarding the customer's location at the time the download or access is performed. Thus, the "termination" location is unknown or if known, might be in a state other than the state with the customer's service address or billing location. In addition, information regarding the location of the Internet server from which the delivery was made or the service provided might not be known or in a state other than the state of the customers services address or billing location.

An associated problem is many state sourcing rules require the seller to source the sale to the state of destination, i.e., the state where the customer is located at the time the product is delivered. Given the nature of electronic deliveries and the proliferation of portable devices allowing digital downloads from most anywhere, the seller often does not know where the customer is located. Frequently, the only information the seller has about the customer is the credit card billing address the customer provided either at the time of sale or at the time the customer set up an account with the seller. However, as noted above, unless the digital sale either originated or terminated in the state of the billing address, the state of the billing address will lack the constitutional power to tax the sale. What is the seller to do?

In addition, many state sales and use tax imposition statutes are geared to sales of tangible personal property and certain enumerated service and were last considered by the legislature at the time they were passed, usually in the 1930s and 1940s, prior to the advent of products that, arguably, are neither fish nor fowl. Yet, we see many state tax administration departments construing these decades-old statutes as applying to sales of digital products and services. Sellers, who are required to collect the tax from the customer at the time of the sale may not be on notice the sale is taxable and they have a collection requirement. During an audit they are surprised to learn the tax department considered such sales taxable and they are liable for not collecting the tax from their customers.

Last, some states specifically impose their sales and use tax on sales of prewritten computer software but do not specifically impose tax on sales of services delivered electronically, such as through the cloud. Once again, we are seeing state tax administrators construing their imposition on sales of prewritten computer software as extending to electronically provided services, where no copy of the prewritten computer software is ever delivered to the customer. Sellers are surprised to learn during an audit that such services are, in the opinion of the tax administrator, subject to sales tax. At this point, the seller likely has lost the opportunity to collect the tax from the purchaser and must pay it out of its own pocket.

There is legislation pending in the Senate that would solve these problems, the Digital Goods and Services Tax Fairness Act, S. 971. This bill would pinpoint the customer's credit card billing address as the proper location to source sales of digital goods and services and would confirm that the state of the billing address has the power to tax such sales. In addition, the bill would require state legislatures to specifically consider whether sales of digital products and services are taxable in their state, relieving sellers of uncertainty over whether such sales are taxable or not. Last, the bill could clearly differentiate between sales of digital goods and digital services, ending the ability of state revenue department to extend a tax on sales of prewritten computer software to electronically deliver service in the absence of specific statutory authority from the legislature.

SoFTEC supports S. 971, the Digital Goods and Services Tax Fairness Act.

Conclusion:

Before exercising its constitutional authority under the Commerce Clause to lift the "physical presence" "nexus" standard for imposing tax collection requirements on remote sellers, Congress first should require states to radically simplify their sales and use tax systems. Our one-rate-per-state for remote sales proposal, outlined above, accomplishes radical simplification. No repeal of the "physical presence" "nexus" standard for sales and use tax collection should occur unless, at the same time, such a standard is codified for state income and other business activity taxes. Last, Congress should pass S. 971, the Digital Goods and Services Tax Fairness Act.

SoFTEC thanks the Chairman and ranking member of the Committee for holding this important hearing and for the opportunity to submit these remarks and ask that they be made a part of the record of the hearing.

May 7, 2012

Hand Delivered

The Honorable Max Baucus
Chairman
The Honorable Orrin G. Hatch
Ranking Member
United States Senate Committee on Finance
215 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: SEMA Testimony: April 25, 2012 Hearing: "Tax Reform: What It Means for State and Local Tax and Fiscal Policy"

Dear Chairman Baucus and Ranking Member Hatch:

The Specialty Equipment Market Association (SEMA) is pleased to provide comments to the Senate Finance Committee in support of the Business Activity Tax Simplification Act (BATSA), legislation to require a meaningful physical presence before a state can impose corporate income taxes on a U.S. business. SEMA is a member of the Coalition for Interstate Tax Fairness and Job Growth, which supports the bipartisan legislation as a way to clarify rules governing interstate commerce and spur economic growth and job creation.

SEMA represents the $30 billion specialty automotive industry of nearly 6,400 member-companies. The industry provides jobs to more than one million Americans in small businesses located across the country. It offers custom accessories that enhance a vehicle's appearance, performance, comfort, convenience and safety. Products include custom tires/wheels, turbochargers, lighting equipment, exhaust systems, suspensions, truck caps, grille guards, leather seating, mobile electronics and sunroofs.

Many SEMA members have received dunning letters from states in which that company has no physical presence. In some instances, these states are claiming up to five years worth of uncollected "business activity taxes" (BAT) and providing a narrow window of time for payment in lieu of legal proceedings.

It is an easy issue to understand. Cash-strapped states have removed the physical presence requirement from their definition of "nexus" in a desperate search for revenues. If you have sold a certain amount of product within the state, you have then created a

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taxable economic presence according to the state. It is a reckless move which defies logic and fairness. Beyond that, each state can define a different monetary threshold since there is no uniform approach, and that threshold can be subsequently changed.

The states have never been able to agree on a single bright-line test for "nexus" and the patchwork approach to economic nexus has compounded the burdens placed on businesses. The states are imposing tax burdens on non-residents who do not benefit from state or local services rather than raising revenues from individuals and companies located within the state border.

At a time when American companies are seeking to emerge from a difficult economy, some states are undermining that effort with punitive taxes. As American companies are asking politicians to reform the tax structure at the federal, state and local levels in order to be competitive in the global market, certain states are imposing regressive BAT taxes.

A company establishes a business plan which forecasts future sales and inventory. The company takes out loans, buys machinery, hires workers, makes products and establishes a distribution system based on that business model. For most companies, the model does not include paying BAT taxes, fines and penalties to a state in which it has no physical presence. This may also require hiring a lawyer and accountant to review the issue and it will require tracking of future sales in order to pay even more taxes. What happens when dozens of other states pursue the same approach? The company may go bankrupt.

SEMA contends that "economic nexus" standards are an unfair intrusion on interstate commerce. They undermine a company's financial well-being and, consequently, the economic well-being for those states in which the company is domiciled and duly pays taxes. The company may postpone expanding and hiring new workers. It may even contract in size. In fact, if the company has to increase the cost of its product in order to pay unanticipated taxes, it may lose market share and become globally uncompetitive.

Economic-based BAT taxes are an especially unfair burden on small businesses. The company has already limited resources when it is complying with a variety of other federal, state and local laws and taxes. For SEMA member companies, of which an estimated 92% are small businesses, this includes compliance with regulations issued by the U.S. Environmental Protection Agency, National Highway Traffic and Safety Administration, Federal Trade Commission, Department of Labor, Immigration and Customs Enforcement, Internal Revenue Service, Consumer Product and Safety Commission and Small Business Administration, to name a few. These companies must also track the laws and regulations for all 50 states along with scores of local jurisdictions. Taxes that have no legitimate basis should be removed from all of the other obligations and challenges faced by small businesses.

The U.S. Congress has a simple solution for rectifying the situation: enact H.R. 1439, the "Business Activity Tax Simplification Act." The legislation creates a reasonable

definition of "physical presence" that allows companies to focus on sales and growth. It permits the company to continue paying BAT taxes to states in which it has a physical presence and thereby contribute toward and benefit from state government services. It is one vital building block towards a predictable tax system.

SEMA urges quick consideration and passage of H.R. 1439 into law. The bill has been approved by the House Judiciary Committee last summer and awaits a House floor vote.

Thank you for this opportunity to share our views. Please feel free to contact me if you have any questions.

Sincerely,

Stephen B. McDonald
Vice President, Government Affairs

STONEWALL KITCHEN
Creators of Specialty Foods

Written Statement of Lori King
Chief Operating Officer
Stonewall Kitchen LLC

Before the United States Senate Committee on Finance

Hearing on Tax Reform: What it Means for State and Local Tax and Fiscal Policy

April 18, 2012

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Written Statement of Lori King
Chief Operating Officer
Stonewall Kitchen LLC

Before the United States Senate Committee on Finance

Hearing on Tax Reform: What it Means for State and Local Tax and Fiscal Policy

April 18, 2012

Senator Snowe and Members of the Subcommittee, on behalf of Stonewall Kitchen LLC, thank you for the opportunity to submit written testimony concerning state taxation nexus issues.

Stonewall Kitchen LLC, is a manufacturer of specialty foods located in York, Maine. We sell our products through wholesale channels, the internet and our catalog business. We also currently have 9 retail locations, including a Cooking School and a Café, which are located in Maine, New Hampshire, Connecticut and Maryland.

As Stonewall Kitchen works towards reaching more and more customers and growing our business we are becoming more concerned with the costs associated with this desire to grow, as states across the country are charging businesses like ours income and franchise taxes even though there are no brick-n-mortar locations or employees in their state. The reason these states are able to impose these types of taxes is because of what they call a "physical presence", such as in our case is due to an independent sales broker.

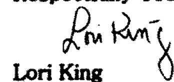
It is becoming increasingly difficult for small businesses to expand and reach into new markets when the burden for such taxes is placed on the business. Not only are businesses responsibility for paying these additional costs, many business must seek the assistance of a third party to assist in the filing and remitting of these returns and payments due to the many tax laws that surround this tax practice by these states, which no business alone can handle regardless of how big or small. This will only

continue to hinder future growth for businesses which will also affect the ability to hire additional employees which could help the economy as a whole.

This is why we are asking for your support to see that Congress will step in and work to ensure that this unfair taxation is stopped. Stonewall Kitchen LLC strongly supports H.R. 1439, the Business Activity Tax Simplification Act of 2011, which will provide relief to the businesses that must endure this additional taxation, not to mention it will once and for all provide a clear decision that states can no longer tax businesses that do not have a true physical location.

We appreciate your time in reviewing this statement and strongly urge you support thc Businсss Activity Tax Simplification Act of 2011. Thank you and I look forward to answering any questions you may have.

Respectfully Yours,



Lori King

Chief Operating Officer

To Whom It May Concern,

Please submit the following statement for the record for the hearing titled, "Tax Reform: What it Means for State and Local Tax and Fiscal Policy" that occurred on 4/25/12.

Tom Pallow
Third Way Progressives
22 Orchid Court
Bellingham WA, 98229-0000

How Obama and Democrats are Not Going Far Enough Regarding Tax Policy and American Job Growth

By Tom Pallow of Third Way Progressives: (202) 903-1133 or tompallow@msn.com

This paper is not at all about what one would commonly imagine upon reading its title. It is not at all about Obama and Democrats not being "progressive" or "liberal" enough. It is about them not going far enough into the radical center, not adopting enough Endogenous Growth policies, or what we call qualityist policies. As of early 2012 Obama and Democrats are certainly not doing these things enough to turn the economy around or to inspire the electorate to vote for him and Democrats this fall.

We are in a unique position in US and world history. The most important change in our lifetimes has been the effective 12 fold increase in global trade that has accompanied the weakening and fall of communism, along with new technologies that make outsourcing across state and national borders as easy and fast as the movement of light. With the fall of communism, every multinational employer in the developed world no longer needed to worry that an investment in an underdeveloped nation might become nationalized by an emerging communist government. This suddenly very different reality opened up a new cheap labor market of 4 billion people. No major nation in the future is ever going to champion socialism or communism, so the old world order is never going to return. Therefore, all successful tax and spending regimes in the future will need to be structured around the realities of this highly competitive global economy. Not only will this new regime make our economy more competitive, but it will make it more egalitarian and more environmentally sustainable than it ever has been.

Regarding tax policy, a good first step in the right direction is the recent plan by Senators McCaskill and Collins to cut the employer payroll tax rate as a way of carving out, or exempting, US employers from any tax increase on the wealthy. Given that about 65% of US employers are taxed at the personal income tax rate, and given that these businesses are generally responsible for creating as much as 90% of America's new jobs, raising taxes on these job providers is never a good idea in a global economy and especially when the economy is weak. US employers are always a very small percentage of tax payers. For example, the McCaskill-Collins carve out would only cost about 13% of their tax increase on those

who make over $1 million that was proposed by them in December to pay for this year's employee payroll tax cut.

There are several reasons why a US employer exemption, or carve out, is very important policy. For one, it is very cheap while it accomplishes much. This is because, with a US employer carve out, the math always works for us. Very little of the earnings of the wealthy, as well as all others, actually comes from the profits of the active ownership of a business that employs in the US. The high mark for this number is about 20%. This comes as incomes reach about $350,000 a year or at about what demarcates the top 1% of US income earners. As incomes go higher and lower from this point this percentage drops quickly. Again, the McCaskill-Collins carve out for those earning over $1 million a year would only cost 13% of the total tax increase. If this new tax incentive to employ in the US were to motivate more of the wealthy to employ in the US so that this percentage were to increase, then great, more Americas would be employed and the increased demand for labor would increase real incomes and tax revenues.

Reason two, when raising income taxes on the wealthy without a US employer carve out, raising taxes on wealthy growing businesses has the effect of slowing the economy to some degree because capital is taken away quarterly from growing businesses who would otherwise use that capital to invest in new US jobs. This is especially true coming out of a recession when about 90% of all new jobs are typically created by businesses that are taxed as personal income, and most of these are within the top income tax brackets.

Thirdly, without a carve out, US employing businesses have an incentive to close up shop in the US and outsource to foreign countries in order to avoid the higher tax. This is especially true within the US when states that raise their income taxes will often see employer flight to US states that are not raising their income tax or do not have a state income tax. This is a big problem right now with our cash strapped states. The current problems in Illinois are just the most recent example, and their example will deter others states from raising their income tax. These states, along with Illinois, will continue their cash flow problems, but a state employer carve out with a state income tax increase would solve this problem. There is more concerning this problem below.

Reason four is one of the most important reasons. The greater the carve out is made, that is, the larger the difference in effective tax rates are made between the US employing wealthy and the non- US employing wealthy, the greater will become the tax incentive for the non-US employing wealthy, or others who want to become wealthy in the future, to find ways to stay wealthy or become wealthy by employing fellow Americans. This tax incentive will greatly increase economic growth and the demand for labor in the US. It is only increases in productivity along with increases in the demand for labor primarily in the private sector that has the effect of raising real wages for the poor and middle class.

Reason five is as important as reason four. Because American voters will soon realize that a US employer carve out tax strategy will not slow down the economy but actually increase private sector jobs, our federal and state governments will be able to raise income taxes far above where Americans would otherwise let them go. As this occurs, the above reason four will only become more pronounced, thus creating a virtuous cycle of increasing private sector job growth that will also be accompanied with increasing government revenues!

Reason six is as important as reasons four and five. These increased tax revenues will allow our governments to fully fund new industrial policy projects that will further grow the US private sector

while allowing us to fully fund current government programs. Fully funded governments, along with a robust private sector that is aided by new industrial policy projects will increase the demand for labor in the US so high as to increase real wages in the US for the first time since 1967 when the global economy really began with the end of the Kennedy GATT trade rounds that signaled the weakening and eventual fall of communism!

Reason seven, our federal deficit and debt problems, along with those of our states, that have the effect of creating economic uncertainty and trepidation that then slows the economy, will be no more!

In his American Jobs Act President Obama proposed an employer payroll tax reduction that holds the possibility of working much like the McCaskill-Collins US employer carve out. The problem is that Obama proposed that this tax cut only exist for one year when it needs to be permanent. We can only hope that if this part of the American Jobs Act were ever passed, a part of this tax cut would be made permanent, along with the Bush tax cuts expiring on the top two income tax brackets, thus creating an income tax increase with a permanent US employer carve out.

If President Obama does not aggressively sell such an idea by the general election season he will lose reelection. Under current proposals, it will not take long before the Republicans will be able to explain that all of Obama's proposed tax increases will only cover about 10% of our federal deficit. Obama's proposed expiration of tax rates on the top two brackets, his Buffet Rule which is essentially a capital gains tax increase on those earning over $1 million, his taxing carried interest at the ordinary income rate, his valuing itemized deductions at 28% for those earning over $250,000, and his elimination of oil tax preferences and corporate jet depreciation will altogether only raise about $150 billion a year while our deficit in 2011 was over $1.5 trillion. Therefore, the president will be asking to raise all of these taxes on a still slow and probably even slowing economy just to cover 10% of our deficit!

I know that Democrats like to point to polls that show that most Americans favor many of these tax increases. But very importantly, if you study the actual wording of the questions in these polls you will see that most of these polls make it appear as though these tax increases would create an equal trade off with spending cuts in order to cover our full deficit. These questions read as though these tax increases would cover 50% of the deficit with spending cuts covering the other 50%. However, given that they would only cover about 10% while likely slowing the economy, the Republicans will easily be able to argue that we have a spending problem not a revenue problem and that Democrats will destroy any economic growth we have. However, with US employer carve outs this problem will be eliminated. In fact, due to reason number four above, we will be able to argue for and enact even larger tax increases. So hopefully President Obama will push for a permanent employer payroll tax cut and sell it as a US employer carve out that would accompany a tax increase on the wealthy.

Better yet, the President and all others looking to create an employer carve out when increasing income taxes should look to institute an Employee Tax Credit along with an employer payroll tax cut. Regarding employer carve outs for income tax increases, while an employer payroll tax cut has some advantages over a US Employee Tax Credit, a US ETC has more advantages, but a combination of the two is optimum. An ETC is a credit against a final income tax bill that has a flour cap at a particular effective rate. For more on US ETCs see our website, ThirdWayProgressives.org.

An employer payroll tax cut does have the advantage that the tax cut is awarded immediately with the first employment of an individual, while with an ETC the tax cut is awarded latter, after a profit is made. The immediacy of the payroll tax cut makes the cost of capital for the employment of new hires lower

than it would be with an ETC. Further, it is important in the global economy to make employing fellow citizens as easy as possible and an employer payroll tax cut helps in this regard. However, Social Security and Medicare must be paid for, and employer payroll taxes cover about 18% of our total federal revenues, so only so much can be cut. For these and another very important reason our tax plan proposes an employer payroll tax cut for new hires while relying primarily on a US ETC to achieve most of the carve out.

The most important advantage of a US ETC is that it will allow our 31 states that do have income taxes to enact state employer carve outs, while with an employer payroll or withholdings tax cut this would not be possible. Given that the economic competition for employment between our states is even more intense than it is between us and other nations, employer carve outs are a must for our states! Employer payroll tax cuts as carve outs are impossible for our states because most of these tax rates are already very low in places, too low to create carve outs. More importantly, these payroll taxes, that usually come in the form of unemployment and disability insurance taxes, are generally structured as to create very valuable tax incentives, with those businesses and industries that have high rates of unemployment and injures paying higher tax rates and those without them paying lower to often extremely low tax rates.

It is very important that these tax incentives are maintained. Therefore, in order to create carve outs, state ETCs will need to be enacted. Further, given that most tax policing is done by the IRS and that states have much less resources in this regard, it would be very inefficient for each individual state to have to do all of its policing for its ETC. For this reason, and the fact that we can only cut federal payroll taxes so far, the federal government should enact a US ECT as part of an employer carve out strategy. Hopefully we are concerned as much about the welfare of our state governments as we are the federal government.

Another very positive feature of December 2011's McCaskill-Collins Bill is its "technology company," venture capital investment tax credit or possible carve out. However, this tax credit's shortcoming is that it is only for investments in technology companies that are expanding in the US, while it should be for investments in all companies that are expanding in the US. Also, many problems will arise be trying to define what a "technology company" is.

Our qualityist capital gains tax plan would raise to 25% today's top capital gains tax rate from 15%. However, it would carve out, and slightly lower from where the rates are today, capital gains tax rates on four basic investments that would all need to have a minimum of jobs created in the US. These for fundamental investments are: first issue bonds, stocks bought at IPO, venture capital investments, and the underwriting of any of the latter three investments. More on our capital gains tax plan can be found at ThirdWayProgressives.org. These four investments are the primary products of the financial market that allow it to raise capital for growing businesses in America. Generally in order to expand, small businesses raise venture capital, medium sized businesses launch IPOs, and large corporations float bonds. With our qualifications for increased employment in the US in order to achieve the lower tax rate, the financial markets will be generating jobs in the US like never before!

The virtues and math in our capital gains tax plan are nearly identical to that of a US employer carve out with an income tax increase. Generally, only about 5% to 12% of all gains in the financial markets come from the above four fundamental investments. However, these four investments are responsible for nearly all of the job growth that is facilitated by the financial markets. It is not that the other products in the financial markets are not important to the economy. It is just that a higher capital gains

tax on them would have little to no effect on American job growth. Except for first issue mortgage backed securities that could also receive a lower tax rate with little cost, virtually all of the rest of the financial products sold are preexisting stocks and bond, and options and derivatives. This other, typically 90% or more, of the financial markets, even with a much higher capital gains tax rate, would retain enough liquidity in their market as to not present any adverse effect on the businesses that rely upon them. However, the more investment we have in the four fundamental financial vehicles, the lower will be the cost of capital for American businesses that are expanding in the US. The greater the difference in tax rate between these four investments and all the other financial vehicles that are generally speculative paper trades, the more American economic growth will occur through financial markets via this tax incentive and the more tax revenues will be raised. Therefore, our capital gains tax regime will allow the federal government and our state governments to be able to raise capital gains tax rates far above were they are today while actually improving the economic efficiency of our financial markets!

Our overall qualityist tax plan also has a C Corporation tax plan that uses ETCs to incentivize job growth in the US along with further rewarding and incentivizing compensation above the US norm for US employees. Our overall plan also contains tax policies designed to create a more environmentally sustainable and safe economy. All of these plans can be found at ThirdWayProgressives.org.

But tax policy is not the only area where we need to adapt government policies to the realities of our highly competitive global economy. Qualityism resides in the world of the New Growth, or Endogenous Growth, Economics School, a school that is only a few decades old and not completely defined. Like most Endogenous Growthers, qualityism believes that economies are affected positively by three primary factors. Like the Keynesians, qualityists believe that it is important that governments take an active role in keeping consumer demand high. Yet like classical, neoclassical, or supply-side economists, qualityists believe that it is very important to keep the cost of capital low for the private sector by keeping taxes low on businesses and capital formation. The above qualityist tax policies and others that can be found at ThirdWayProgressives.org destroy the policy catch 22 that we have been in for the last 100 years regarding this unfortunate tradeoff between Keynesian and supply-side economics. Our new global economy is too competitive, complex, and demanding to put up with this catch 22 any longer! But qualityists also believe that there exists a third primary engine of economic prosperity that is at least as important as the other two. This engine is the emergence of new technologies and methods of production.

Like New Growth or Endogenous Growth economists, and like those on the right who call themselves Real Business Cycle theorists, qualityists see economic growth and the business cycle as being dominated by the arrival of new technologies, products, and methods of production that will be bought and invested in even if consumer demand is low or the cost of capital is high. When one examines historically how relatively small portions of the economy can be responsible for very large portions of the growth of an economy the reality for this perspective becomes extremely evident. Some studies have shown that as much as 60% to 90% of the economic growth in an expansion occurs in what begins that expansion as only 2% to 3% of GDP. For example, housing, healthcare, and cell phones were responsible for an extremely large percentage of economic growth in the US between 2002 and 2008. Between 1992 and 2000 it was personal computers and the internet that drove growth. Between 1982 and 1990 it was commercial real-estate and computers for businesses. In the 1970's it was gasoline and inflation. In the 1960's it was aerospace and war. In the 50's it was TVs and other consumer electronics. In the 40's it was war, in the 30's government, in the roaring 20's cars, trucks, and radios, and in the 10's cars and war. Before 1913 there took place shorter economic cycles that were most effected by railroad expansions.

Yet unlike Real Business Cycle theorists who believe that the best policy is for governments to simply not get involved and let this real cycle play out, Endogenous Growthers and qualityists believe that the government should, and has in the past but never optimally or efficiently done so, facilitate and add to new technological development. When one recognizes that the private sector alone has never been able to produce at close to peak potential scientific and technological outputs, and given our need for more environmentally sustainable technologies among others, it is easy to realize that the government should be doing much more in this area. It has been said by those who study the subject that the free market alone only generates about half of the R&D that the economy could efficiently produce.

A majority of the most impressive achievements of mankind were financed and designed with government funding, from the pyramids in Egypt, to the ships that were designed via Prince Henry the Navigator of Portugal and then financed by the royalty of Spain that discovered the New World, to the moon landing, satellites, and the internet. Moreover, war financing has generated much technological improvement, from arguable everything but the pyramids above, to many improvements in the combustible engine and most improvements in aerospace. Given our technological needs as a growing species with only one planet, we should not rely on the inefficiencies of war as the catalyst for needed technological improvements!

It is wealth and better technologies that allow societies to preserve their environments while acquiring what they need and desire, not economic constraints and poverty. The poorest and least politically and economically free nations of the world are all its least environmentally preserved. Therefore, it is the free market in accordance with predictable, transparent, and robust government R&D support, along with tax incentives both on the purchasing and profit end, which will preserve our environment. But it is also the free market with such government support that will best allow us to fulfill our economic needs, wants, and dreams that are not hampered in any major way by environmental concerns. The people of the world are made better off if a favorite play toy of many that the private sector alone would have taken 50 years to develop is there to enjoy 25 years earlier because a government helped in the development of that product and production. Further, when structured properly, workers are able to engage in jobs that produce higher rates and qualities of output while enjoying a larger share of this output.

For all of these reasons an important feature of qualityism is structuring the most fair and economically efficient way for the government to assist the private sector in increasing the economies overall scientific and technological output. As importantly, qualityism is structured so that the people of a nation who pay for their government's successful R&D support receive just compensation for these expenses while their workers are able to benefit from an increased demand for their employment. For this to be done in a way that is predictable, transparent, and not swayed by political influence is of utmost importance. Fortunately, such a method is also one that would be most economically efficient and without waist.

In the last several years our federal government under programs like the Energy Policy Act of 2005 and the assistance of General Motors has began to move in this proper direction. However, many of these programs have provided assistance at points of production that create waist and can be adversely altered by political influence. It is very important to remember that the point of production where government can assist the private sector with the least amount of waist and adverse political influence is during the basic and applied research and development stage.

President Obama's newly proposed National Network for Manufacturing Innovation at first glance looks to be the right step in the right direction, as has long been the Brookings Institute's Energy Discovery – Innovation Institutes. However, with only $500 million to $1 billion to be spent over four years with the new NNMI, this is a baby step when an Olympic long jump is needed. Nonetheless, if structured properly it will take relatively little time before it is found that this program more than pays for itself. I don't mean "pays for itself" using typical squishy Washington DC accounting, so the monies earned through the program could be ploughed back into it. However for now, at the very least and with this year's election, a real commitment to this program needs to be made!

What is suspected that the NNMI would do because it is reported to be molded after Germany's Fraunhofer Institute is to invite as many private business participants as possible to come together along with the government to brainstorm over what possible technological developments they would like to collaborate in developing that they would all find benefit in using once developed. Those ideas that attract the most private sector R&D investment commitments would then also receive government R&D funds and other basic science support. With the right government incentives the intellectual property developed would then be produced and used in the US.

At present there is a debate within the administration as to whether the NNMI should be structured with incentives for businesses to manufacture in the US those products that arise using the NNMI government funds. Unless China and India offer to pay, and I don't mean lend, the NNMI funding, the answer to this question should be yes. More specifically what should happen is that as federal, state, and local funds begin to rise on a particular project, so too must correspondingly rise the percentage of payroll that a business has in each jurisdiction relative to its global payroll in order for it to have a right to the intellectual property developed. Failure to do so would mandate very high royalties and fees in order to use the intellectual property. Further, the best way to calculate payroll increases would be to measure them through the amount Employee Tax Credits earned. Given that our ETCs as part of our personal income and corporate tax plans allow for ever greater ETC rewards that can be given to businesses that compensate their employees at ever greater amounts above the norm, the NNMI would then maintain, create, and attract higher paying jobs in the US. Germany's Fraunhofer Institute provides 70% of its funding via its own internal profits, with only 30% of its funding coming from German governments. With the right incentives and tax structure the NNMI would more than pay for itself!

Such institutes in the US will need to expand far beyond what is being proposed above. A very extensive NNMI along with robust state involvement and connected institutes through business incubators and our universities will be a must. One of the missions of our universities should now be to be their own business incubators with manufacturing institutes. Large patent pools and networks should be formed within and among them. Students, private groups, and perhaps even non-affiliated individuals would give up exclusive intellectual property rights in exchange for a predetermined percentage of royalties. The exclusivity of each patent pools would be determined by the university and each program coordinator. Private investors, existing businesses, and those within the business incubators would then be able to license any such patents with similar payroll, ETC, and/or royalty commitments as would exist above with the NNMI. Further, universities should stop using not always relevant math courses as "weeder" courses into many science and engineering degrees. Albert Einstein, perhaps the greatest physicist of all time, was a well below average mathematician. It is safe to say that many of the futures greatest inventors and scientists may be the same.

All of this will be part of a transformation of our universities that is typical for a time period that has experienced an even more profound economic transformation, our rapid movement into the global

economy. After the Civil War and around the turn of the last century the mission of America's universities was greatly broadened. Prior to the Civil War American college students could typically only receive degrees in one of five subjects: law, medicine, theology, philosophy, or science. But as our economy was rapidly transformed from agricultural to industrial during this period, within our colleges and universities the subjects of philosophy and science splintered and became specialized eventually into what we know them to be today. During this period higher education became much more relevant to the needs of society. A similar revolution is now upon us, and reluctant schools will only suffer.

Given this reform to higher education along with the NNMI it would not take long until the economies scientific and technological output would be taken to a more desired level. Along with various environmental tax incentives and programs, the possibility of maintaining a pristine and safe environment for the US and the rest of the world would greatly increase. On the purchasing end, the federal, state, and even local governments could enact an Environmental Fair Tax. For states and local governments this would simply mean that they would structure their sales taxes such that products with a great environmental rating would receive a very low to no sales tax, while products with low environmental ratings would make up for this cost by having much higher sales tax rates. This tax would be revenue neutral. A federal Environmental Fair Tax would piggy back on the state and local sales tax system, lowering sales taxes even further for products with great environmental ratings while raising sales taxes even further on those with poor ratings.

Our other environmental tax proposal would reword tax credits for the production of products using best practices. Just like with an Environmental Fair Tax on the federal level, the EPA could designate, and then Congress and the president could OK, best, standard, and poor practices, and then award a lower income tax rate via this designation. Also just like with an EFT, these practices could be judged for what is generated for the production of a product, when a product is in use, and when a product is discarded. Another very positive proposal for the environment is to have the federal government announce that the first some odd amount of the production of a certain best practice could be produced tax free. All of these tax incentives would slowly but inevitably create a cleaner environment as new best practices are invented and old best practices becomes standard practices and so on. With these tax policies understood as being permanent, given potential technologies being even close to equal, engineers will always default to employing the more environmentally friendly technology. Furthermore, given that the overall output of environmentally friendly technologies will increase under qualityism, if the free market with these tax incentives alone is not enough for a given sector to move away from certain less environmentally friendly products and procedures, it will then be easier for governments to mandate the use of cleaner technologies without adversely affecting the economy.

But what qualityism would best achieve over time is a more egalitarian society! Our tax plan would raise far more government revenues than any other currently proposed tax plan. Much of these new revenues could be used to improve education. Greater educational opportunities are liberating for both individuals and the overall economy. Until the last few years, greater educational outputs have been virtually the only policy initiatives of Endogenous Growth Economists. A more highly educated work force will entice capital and job growth, along with raising productivity and incomes. Meanwhile the tax incentives in qualityism also increase the demand for labor in the jurisdiction of the government that employs them. In the end, given that government can never be larger than the private sector that creates it and keeps it alive, it is only the demand for labor in the private sector and increases in productivity that can overtime raise real incomes for workers. These tax incentives, along with the NNMI and our proposed incentives for their associates to employ domestically, would ensure that the demand

for labor in the domestic private sector is at its optimum, along with ensuring that desired scientific and technological outputs are at their optimum.

With a greatly increased demand for labor and better technologies that will increase productivity, clean the environment, and deliver better products, workers will be able to demand more of better products, and/or more time off and vacations if they so chose. A great demand for labor will put workers in greater control. Moreover, free market entrepreneurs will have more opportunities than ever before to rise and become wealthy, while everyone will have a more prosperous life even if they chose to do less, all while creating a more environmentally sustainable economy. The economy will be of a higher quality, and this will give all individuals more of an opportunity to do what they dream. Such is the essence of anything that is liberating.

Qualityism liberates us from the failed philosophies of both Keynesianism and neoclassical economics. Keynesians, especially in a competitive global economy, adversely constrain and shun the private sector while far too often they spend through the government in ways where economic efficiency is inadequately measured. Meanwhile, neoclassical economists or supply-siders fail to live in the real industrial economy where, without government or union intervention, consumer demand by the masses is never able to keep pace with the rest of the economy, leading to an ever slower and less prosperous economy. Unfortunately today in our global economy, the only redeeming value of either economic philosophy, and therefore most of the beliefs either political party, is that their advocates block the other party from completely running, and therefore completely destroying, our economy!

Unfortunately for Democrats in our global economy, it would take Keynesians less time to destroy our economic prosperity than it would for supply-siders to do so. Certain destruction would come with supply-side policies, but a slower certain destruction. The American people sense this, and this is why since the global economy really began with the end of the Kennedy GATT trade round in 1967 Democrats have only had one two term president while the Republicans have had three. Further, every exit poll showed that that without Ross Perot running Bill Clinton never would have won in 1992, so the Republicans would have had a fourth two term president and the Democrats zero. In order to win in 1996 Clinton had to "triangulate" and become a "New Democrat." Without Watergate, the financial crash in the fall of 2008, and Ross Perot, it could have been a complete wipeout for Democrats since 1967. No president has ever been reelected with such a poor approval rating this close to an election as President Obama now has. Democrats can pretend this is not a problem and continue to lose, as the American people continue to lose. Or they can face reality and adopt Endogenous Growth, qualityist policies, thereby improving their lot and more importantly the lot of the American people.

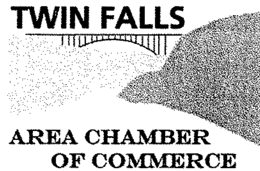
Exactly 100 years ago, as the most developed economies of the world experienced an equally pronounced and profound economic transformation as our sudden movement into a global economy, the Democratic Party took up the mantel of the progressive income tax and other progressive legislation as a way of adapting to the sudden movement from a primarily agricultural economy to a primarily industrial economy. This economic transformation was primarily due to their recent development of electricity, mechanized farm equipment, and railroad expansion. In an agricultural economy, during a recession people can remain or move back to family farms and live off of them. In an industrial economy this is much less so. Plus, industrial economies have to deal with non-reinvested profits that disallow workers to be able to keep their consumer spending at pace with the rest of the economy, thereby helping to bring on recessions. Only progressive income and capital gains taxes can increase consumer spending by the poor and middle class because all other forms of taxation are regressive so they cannot increase moneys to the poor and middle class. These are the reasons why between 1910 and 1915

virtually all of the economically developed nations of the world enacted for the first time, with a few short exceptions in Britain and the US in order to pay for 19th century wars, progressive income taxes, along with other progressive legislation. All of these nations, and soon after most of the nations of the world, have had progressive income taxes ever since.

Today we still live in an industrial economy and hopefully with vigor want to remain in one. Therefore, we still must redistribute income in order to keep consumer demand up, and we must do it through progressive income taxes. However, given our now highly competitive and employment mobile global economy we must counter our progressive income and capital gains taxes in a much more sophisticated manor that does not damage domestic job growth but actually incentivizes it. Income and capital gains taxes make up about 55% of our federal revenues and the top 5% of income earners pay about 70% of these taxes. The top 5% or higher of income earners is where the money is, and this is where we must acquire it. However, and very importantly, our qualityist income and capital gains tax plans increase taxes only on the moneys in the economy that are LEAST responsible for domestic economic growth while incentivizing domestic economic growth!

No major nation of the world in going to champion communism or socialism and take this world back to the pre-global economy days. The lesson that has been learned by effectively all the world that came out of the grand struggle of communism and socialism against the free market is that a private economy with a profit margin is much more efficient and liberating then is a government controlled economy without a profit margin. Communism and socialism have been permanently discredited and there is no going back. The global, industrial, free market economy is here to stay, until sometime long after we are dead it transforms into something different. If the US were to now champion qualityism, it would not take long until the rest of the world had more democratic, free market, qualityist governments which would therefore have higher labor and environmental standards. This would in turn allow the US and the other economically developed nations of the world to have ever higher labor and environmental standards. Our governments much better fiscal position under qualityism, along with similar governments and fiscal positions in Europe and Japan, would also give these democratic nations much greater influence upon the world and upon all undemocratic nations both large and small.

Just like with what was done 100 years ago, the Democratic Party must lead the way in applying new policies to a new economic reality. Being the "conservative" party, or in other words the "slow to little change" party, we cannot rely on the Republicans to champion these new policies. The Democratic Party also led the way during its inception during the Second Great Awakening of the early 1800's by championing very important democratic reforms that made our democracy much more representative. The early part of each century, following a cycle of four roughly 25 year long generations, or a cycle of roughly every 100 years, has always experienced a profound and very substantial redefinition of what people considered to be politically and socially liberating. This occurred during the Progressive Era of the early 1900's, the Second Great Awakening of the early 1800's, the Great Awakening of the early 1700's, the Puritan Awakening of the early 1600's, and the Protestant Reformation of the early 1500's. This 100 year cycle in this manifestation appears to have begun with the great period of nation building in Europe in the late 1400's that was primarily a result of the invention of the canon and the printing press during that century. However, a paralleling sequenced 100 year cycle of new and profound societal changing ideas appears to have followed this same pattern as far back as into the ancient world. But most importantly for us, an Awakening of more modern magnitude is, and must, now be upon us. The sooner we accomplish what past generation have and rise to the challenge of history, the better off we and all future generations will be!



Wednesday, April 25, 2012

Comments for inclusion in the hearing record for:
Tax Reform: What It Means for State and Local Tax and Fiscal Policy
Held before the United States Senate Committee on Finance
Wednesday, April 25, 2012, 10:00 AM

Submitted by:
Shawn Barigar
President / CEO
Twin Falls Area Chamber of Commerce
858 Blue Lakes Blvd. N.
Twin Falls, ID 83301

Distinguished Members of the United States Senate Committee on Finance:

Thank you for the opportunity to share my views and those of the individuals businesses which I represent as the President / CEO of the Twin Falls Area Chamber of Commerce and also as Chairman of the Idaho Chamber Alliance, an alliance of chambers of commerce from across the state committed to making an impact on the issues that affect our businesses, our economies, and our communities. There is a very serious issue that is threatening local retailers and the communities they serve, both in Idaho and across the country.

The issue is fairness when it comes to collection of Sales and Use Taxes for bricks-and-mortar Main Street businesses versus online marketplaces with no physical presence in our state. You've had information presented in the past related to this issue under several different names including the Main Street Fairness Act and the Marketplace Fairness Act – designed to level the playing field for these two types of important business entities in our nation...but which follow different – and unfair – sets of rules when it comes to collecting these taxes.

In Idaho, we have worked for the past several years to pursue legislation to include Idaho in the Streamlined Sales Tax consortium. Unfortunately, the issue has met resistance from our lawmakers. During this past Legislative session, the issue once again failed to gain support and the bill to join the Streamlined Sales Tax effort and make the changes to Idaho Code to comply did not pass out of committee.

One of the issues raised by our Legislators was that there needs to be a nation-wide guidance on this issue as it has implications in every state and needs to be implemented uniformly and fairly across the United States.

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To put it simply, Main Street businesses across the country will continue to suffer, shed jobs and economic input, and close up shop altogether unless Congress acts to implement e-fairness legislation.

Right now, as you probably know, local Idaho retailers are unfairly disadvantaged by a loophole in our nation's sales tax laws that allows online-only retailers to avoid collecting and remitting state sales and use taxes. This puts bricks-and-mortar businesses in Idaho at an automatic price *disadvantage* of six percent in my state. These local businesses are already faced with additional taxes and fees and a shaky economy as it is—this sort of tax inequity makes staying competitive in today's increasingly challenging economy nearly impossible.

Brick-and-mortar, Main Street businesses are the lifeblood of our local communities. They supply much-needed jobs, provide economic input, and support the cities, towns, and neighborhoods in which they are embedded. They should not be burdened with an unfair sales tax structure that punishes their customers for doing their part to support local communities.

As technology continues to advance at an exponential rate and our consumer marketplace environment changes, Congress should address these inequities between bricks-and-mortar retailers and those conducting business online.

When government policy favors one class of business over another, as is the case here, that isn't a free market. That is an unlevel playing field. It's time for Congress to restore fairness to the marketplace by standing behind legislation like the Marketplace Fairness Act or the Main Street Fairness Act.

Many of our Idaho legislators, our Idaho Governor C.L. "Butch" Otter, our chambers of commerce, and – most importantly – our citizens and our businesses leaders are calling for a solution for this problem. We're asking you – our Members of Congress – to stand together to support legislation to help preserve Main Street businesses and the communities they serve, in Idaho and across the country.

Thank you for your time and consideration.

Sincerely,

Shawn Barigar
President / CEO

EXECUTIVE COMMITTEE
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Francisco Uribe
Home Depot
Treasurer
Madeline White
Merle Norman Cosmetics
Chair
Governmental Affairs
Kevin Groff
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Chair
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Kevin Groff
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Retrospective Ratings Program
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Chuck Miller
Macy's
Rick O'Connor
Super Color Photo
Perry Saueressig
Ben Bridge Jewelers
Jennifer Spall
WalMart

April 30, 2012

Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD-219
Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Re: Supplementing the Record for the April 25, 2012 Hearing on "Tax Reform: What it Means for State and Local Tax and Fiscal Policy"

Dear Committee Staff:

On behalf of the Washington Retail Association, our members and a collection of Washington State business interests, we request that the attached letter be included in the official record of the above hearing. The letter was sent last week to members of Washington's congressional delegation urging them to support legislation that closes the so-called Internet tax loophole. Since last week's hearing touched on that issue, we feel the letter is relevant to the Finance Committee's deliberations as well. Thank you, and do not hesitate to contact me if you have any questions.

Sincerely,

Jan Teague
President/CEO
Washington Retail Association

April 27, 2012
(updated from April 24, 2012)

Dear Members of the Washington State Congressional Delegation:

We are writing to urge you to support legislation that addresses the current competitive imbalance caused by the so-called Internet tax loophole. The undersigned companies and associations represent a diverse set of business interests from across the state, but we are united in our goal of creating a level playing field between online-only and traditional retailers. With the rapid growth of shopping at home, by smartphone and by tablet, all retailers are motivated to respond even more quickly than ever to consumer demands. But when federal law is tilted to advantage one type of seller over another, the long-term competitive foundation is weakened. Upstanding businesses that comply with in-state requirements, and that every day work to meet consumers' needs, see sales lost and business eroded merely as a result of an imbalance in federal law that Congress can fix.

In the Senate, a bipartisan group of senior Senators is co-sponsoring the Marketplace Fairness Act (S. 1832), and in the House, the Marketplace Equity Act (H.R. 3179) is co-sponsored by a bipartisan collection of over 30 Members. While not identical, both of these bills would empower state legislatures to require remote sellers to collect and remit sales taxes to the location where an online or catalogue sale is being completed. Importantly, no state could impose this obligation unless it adopted a simplified process for remote sellers, as well as an exemption for companies that conduct a limited amount of business online.

Last December, the Washington state legislature passed Joint Memorial 8009, noting that today's status quo puts Washington state sellers at a competitive disadvantage and that the situation destabilizes an important revenue source for both state and local governments. In February, Governor Gregoire included this issue among her top priorities in her letter to you. The Washington Department of Revenue has projected that closing the Internet tax loophole would yield an estimated $170 million in the current biennium and over $480 million in the next biennium – *not* in new taxes, but merely by assuring that taxes already due are collected.

Washington is home to a wide range of large and small retailers that operate locally and sell their goods to customers from across the country, employing thousands of people and supporting economic growth. The National Retail Federation estimates that the retail sector is directly responsible for over 600,000 jobs in our state and that the total employment impact (including a multiplier effect) is over 880,000 jobs -- nearly one in four jobs in the state of Washington. The current imbalance in tax collection and remittance obligations puts many of those workers and their employers at an unfair disadvantage.

We urge your support in rectifying this situation, and we thank you for advancing federal policies that ensure economic competitiveness and job creation for Washington businesses.

Sincerely,

Association of Washington Business
Ben Bridge Jeweler
Economic Alliance of Snohomish County
ExOfficio
Greater Vancouver Chamber of Commerce
Kittitas County Chamber of Commerce
Nordstrom, Inc.
Outdoor Research
Recreational Equipment, Inc. (REI)
Sur La Table
Washington Automotive Wholesalers Association
Washington State Veterinary Medical Association
Bellevue Chamber of Commerce
Cascade Designs, Inc.
Eddie Bauer LLC
Fred Meyer Stores
Kemper Development Company
Les Schwab Tire Centers
Northwest Tire Dealers Association
Pacific Northwest Booksellers Association
Seattle Metropolitan Chamber of Commerce
Tri-City Regional Chamber of Commerce
Washington Retail Association
Zumiez, Inc.

Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD-219
Dirksen Senate Office Building
Washington, DC 20510-6200

Tax Reform: What It Means for State and Local Tax and Fiscal Policy
April 25th, 2012
CC: Senator Roberts

As the owner of Watermark Books & Café in Wichita, KS, and as a member of the American Bookseller's Association, I would like to strongly urge your direct involvement in the internet sales tax issue by supporting the Marketplace Fairness Act (S.1832) legislation. This Act would put an end to online companies dodging our state sales tax and that of other states. With this federal legislation in place, online sales tax in every state will be manageable and enforceable, and we need your support to make it happen.

Not only is the current sales tax system unfair to brick-and-mortar businesses in our communities, but it is also unfair to those individuals who pay the state sales tax as an honest citizen. The individuals who choose not to pay our state sales tax are still benefitting from those of us who do pay. Bottom line, we need the sales tax system to be one, universal system that will keep the playing field leveled between all states.

It is estimated that each year states lose out on $23 billion in sales tax. Imagine all of the improvements our state could make with that lost money – not to mention what it could do for our budget shortfall in Kansas. The money that goes uncollected by states each year is growing, and we need to do something about it. We need to hold online businesses accountable across the country and this is the only way to do it.

I hope you will join me in supporting the Marketplace Fairness Act (S.1832).

Thank you for your time and consideration.

Sincerely,

Sarah Bagby, Owner
Watermark Books & Café
Wichita, KS

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