Statement of
Patrick T. Carter
President
Federation of Tax Administrators

Before the

Subcommittee on Courts, Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives

H.R. 1864
Mobile Workforce State Income Tax Fairness and Simplification Act of 2011

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Introduction

Chairman Coble, Vice Chairman Gowdy, Ranking Member Cohen and Members of the Subcommittee thank you for the opportunity to address the Subcommittee on H.R. 1864. I am Patrick Carter, President of The Federation of Tax Administrators (FTA). FTA is an association of the principal tax and revenue collecting agencies in each of the 50 states, the District of Columbia, and New York City. Our purpose is to improve the techniques and standards of tax administration through a program of research, information exchange, training, and representing the interests of state tax administrators before the Congress and Federal executive branch.

Summary

FTA has worked on this legislation with the Committee's staff and industry representatives for several years now and we regret that, except for a reduction in the days threshold, none of the changes we suggested to the last version of the bill have been included in this version. As a result we must oppose enactment of H.R. 1864. As drafted, we believe this bill invites tax avoidance and makes normal tax administration of this area virtually impossible. The bill is an unwarranted intrusion into legitimate state tax authority and sovereignty.

If Congress moves into this area, it should balance several interests. We have developed criteria for evaluating legislation in this specific area. Any resolution of the issue should, at a minimum, meet the following criteria:

a. The action should be clearly limited to wages and related remuneration earned by nonresident employees. The legislation must also be clear that it is not intended to impair the ability of states and localities to tax non-wage income earned from the conduct of other economic activities in the taxing jurisdiction.
b. The action should provide that a state or locality may impose income tax liability on a withholding obligation with respect to the wage and related remuneration of a nonresident if the nonresident is present and performing services exceeding a de minimis threshold in a calendar year.
c. Alternatively, the threshold could be formulated as limiting state and local income taxation (and withholding) to those nonresidents present and performing services in the jurisdiction whose earnings exceed a de minimis threshold in wages and related remuneration in the prior year.
d. The action should provide that all persons paid on a "per event basis" are excluded from the coverage of the bill.
e. The action should provide for the allocation of a day to a nonresident jurisdiction when services are performed in the resident jurisdiction and another jurisdiction in a single day.
f. The action should cover wages and remuneration earned within a jurisdiction in a calendar year so as to not disrupt taxation of any deferred amounts. It should not, however, impair the ability of states and localities to tax income arising from the conduct of other economic activities in the taxing jurisdiction.
g. The effective date of any action should be delayed until the beginning of the second calendar year following enactment to allow sufficient time for implementation by state and local governments and affected employers.

The criteria above should not be interpreted to imply that FTA considers that a physical presence standard is in any way an appropriate standard for establishing jurisdiction to tax in other contexts, particularly for the imposition of business activity taxes on entities doing business in a state. FTA is firmly opposed to Federal legislation that would establish a physical presence nexus standard for the imposition of business activity taxes.

Concerns with H.R. 1864

If Congress intends to pursue legislation in this area FTA believes the legislation should be revised as follows.

Records Used in Determining Withholding Obligation. H.R. 1864 provides that for purposes of determining an employer's withholding obligations, an employer may rely on an employee's determination of time in a state unless the employer has "actual knowledge of fraud by the employee..." It further provides that an employer is not required to use records regarding the location of an employee that it may have unless it maintains a "time and attendance system" that "contemporaneous[ly] records the work location of the employee for every day worked and the employer uses this data to allocate the employee's wages between all taxing jurisdictions in which the employee performs duties." These provisions, taken together, appear to be designed to absolve employers of virtually any obligation to use information that they have at their disposal in determining whether an employee is subject to a withholding requirement (and consequently a tax liability) in a state. Instead, they let the employer rely solely on an employee's estimate of the time he or she may have performed services in a state. Relying on employee records makes it virtually impossible to audit an employer's withholding obligation. Audits must be done on each employee to determine if withholding should have taken place.

FTA recommends two changes in this area. First, the fraud standard in Section 2(c)(1)(A) should be eliminated, and the employer should be allowed to rely on an employee's estimate of time in a state unless the employer has "actual knowledge" that the employee's estimate is in error. Fraud is an exceedingly high standard to prove, and the purpose here is to determine if an employer has a withholding obligation, not whether there is some intent to evade taxes. Second, as to the "time and attendance system," we find the language to be overly narrow and protective of the employer. We recommend that Sections 2(c)(2) and 2(c)(3) be replaced by a requirement that if an employer in the normal course of the business maintains records that record the location of an employee, such records should be used to determine whether an employer has a state income tax withholding and information return obligation. If the records are maintained and considered sufficiently accurate for other business purposes, the records should be used for purposes of determining the applicability of state tax withholding obligations.

30-Day Rule. Beyond the policy concern of intruding into state authority, the dominant concern of states is the 30-day rule contained in H.R. 1864. It will effectively convert state income tax systems to residency-based tax systems and goes well beyond what is necessary to deal with the burden and compliance issues present in the current system. It will allow an individual to work in a jurisdiction for over 12.5 percent of a work year and be absolved of any liability to the state in which he/she worked. This is certainly more than is required to deal with the compliance and burden issues that the bill was intended to address. It will effectively limit nonresident taxation to those that work permanently in another state or are assigned to a state on a continuing basis; it is certainly well beyond any level that is necessary to deal with individuals who travel regularly as part of their jobs e.g., attorneys with litigation, training personnel, meeting organizers, as well as government affairs and sales personnel.

It is the excessive nature of the 30-day rule that contributes to the substantial revenue impact that the bill has on certain states, particularly New York State because of the nature of its economy and its role as an international center of finance and business. While we would not argue that accounting for minimal amounts of time in a jurisdiction is always practical, the proposed 30-day rule is over-reaching. It is certainly more than is necessary to deal with the burdens employers might face.

Dollar-denominated Threshold. FTA believes that if legislation is enacted in this area, the de minimis threshold should also have an income component in addition to a time component. That is, state tax obligations would be triggered if the total of wages and remuneration paid to an employee for services in a state exceeded a specified amount of income or if the employee exceeded a certain number of days in the state. This is similar to the approach used in the U.S. income tax system to determine the taxability of income paid to a nonresident alien.[1] As noted, H.R. 1864 exposes some states to significant revenue shifts and disruptions based on the preliminary estimating work that has been done. The addition of a dollar-denominated threshold will reduce the exposure of states to revenue disruptions. In our estimation, it can be done in a manner that does not impose undue burdens on employers or employees.

FTA recommends that the de minimis formula should be "bifurcated" and formulated as follows: (a) An employer would have a withholding obligation only if the employee is a resident of the state or is present in the state in excess of some specified number of days; and (b) an employee should be subject to a state's income tax if she/he: (1) is a resident of the state; (2) exceeds the withholding threshold denominated in terms of time; or (3) has income in excess of some dollar threshold in a state.

Such a construct would provide employers with the certainty and simplification they require to efficiently handle their withholding obligations. At the same time, it provides states with protection against substantial disruptions to their revenue flows. Concern has been expressed that this approach could leave employees in a situation where they would have a tax liability without any withholding having occurred. This, of course, is no different than the current system, and we believe that if the threshold is properly constructed, it is a situation that would affect relatively few employees that should, in conjunction with their employers, be in a position to manage their affairs to avoid the situation.[2] In our estimation, the reduction in the exposure of state revenue systems requires adoption of this approach if Congress intends to pursue legislation in this area.

[1]Section 861(a)(3) of the Internal Revenue Code provides that compensation for labor or personal services performed in the U.S. is not be deemed to be income from sources within the U.S. if (A) the labor or services are

[2] For example purposes only, consider if the bill imposed a threshold of 20 days in a state or $20,000 in income allocable to a state. In such a case, an employee would have to earn in excess of $260,000 per year in order to exceed the $20,000 threshold (gross income before any deductions, exemptions, etc.) without exceeding the 20 days threshold (based on 260 working days per year.) Employees in this income range should reasonably be able to assess the states in which they are likely to exceed such a threshold in a given year and make arrangements with their employer for withholding if he/she so desires.

Definition of "Day." Section 2(d)(1) of H.R. 1864 defines "day" as any day when the employee is physically present in the state or locality and performs "a preponderance of the employee's employment duties in such State or locality for such day." We would recommend that this be changed to substitute "all or any part of a day in which the employee is present and performs services in the state."

As now written, this provision will do anything but bring clarity and simplification to the determination of when an employee may be subject to tax and when an employer may be subject to withholding. Instead of providing a bright line, it asks employers and employees to make a determination about the proportion of their duties (an undefined term) that were performed in the state. "Duties" could be interpreted to mean specifically assigned obligations or something mandated by an employer, rather than perhaps all the services performed by an employee. Further, how is a "preponderance" to be determined – by time, value of the duty to the employer or some other measure? If it is difficult to determine where an employee is on any given day (as proponents of the bill have argued), it is immeasurably harder to have consistent documentation on where an employee performed a majority of his/her duties for the day. We believe this provision, besides being unclear, could lead to manipulation and gaming the system.

Converting the standard to "all or any part of a day in which the employee is present and performs services in the state" will provide clarity in determining when the withholding and liability thresholds have been met. These are easily understood and commonly used terms. The Committee should also note that for purposes of determining when a nonresident alien being paid by a foreign corporation is subject to U.S. income tax, one of the determinations is how many days the individual is present in the U.S., and "day" is defined as "any part of a day" for Federal income tax purposes. Finally, in evaluating this recommendation, the Committee should keep in mind that the definition of "day" affects only whether the withholding/liability threshold is met and not the amount of any liability.

Compensation Paid Over Multiple Years/Stock Options. H.R. 1864 provides no guidance and will likely disrupt established state policies on an increasingly frequent form of compensation – stock options or other compensation paid in one year for services performed in an earlier year. Most states have developed rules for this compensation that would be affected by the bill. It is not uncommon for states to allocate option income earned by a nonresident to a state based on the proportion of time worked in the state from the time the option is granted to the time it is exercised (i.e., the stock is purchased at the price offered in the grant).[3] (For federal tax purposes, income earned during this period is treated as taxable compensation and not capital gains income.) Under H.R. 1864, it could be argued that if the individual does not exceed the 30-day threshold in the year the option is exercised, a state may not be able to tax the portion of the income earned during that period even though it is normally treated as taxable compensation and the individual may have exceeded the threshold during the years from grant to exercise. In other words, by imposing an arbitrary (and excessive) days-based threshold on when a taxpayer is subject to tax in a state, H.R. 1864 will disrupt established state tax policies that are based on the accepted source tax principle and are designed to deal with a relatively complex, but increasingly common, form of compensation. Disrupting practices in this area has the potential to exacerbate the revenue loss considerably. Including a dollar-denominated threshold for when a tax liability is incurred by an employee within a state would also help address this problem and reduce the disruption to state revenues.

Certain Public Figures. The bill is drafted so as not to apply to certain types of individuals that are paid on a "per event" basis because such individuals know where they are and how much was earned for the event. We believe, however, that the term "certain public figures" and "persons of prominence" are rather imprecise and could lead to litigation, etc. We recommend instead that the bill be amended simply to provide that "persons paid on a per event basis" are not to be subject to the terms of the bill.

"Cliff" Effect. H.R. 1864 (Section 2(b)) provides that if an employee crosses the 30-day threshold, withholding shall commence from the first day the employee performed services in the state. That is, if an employee crosses the 30-day threshold in November, the December wage payments to the individual would have to reflect withholding for all 30-plus days. This seems to us impractical and could work a hardship on the employee. Importantly, this is really a reflection

[3] See Jack Trachtenberg and Paul R. Comeau, "State Taxation of Stock Options," Presentation to FTA Annual Meeting, Chicago, Illinois, June 2007.

of the excessive nature of the 30-day requirement. A significant reduction in the 30-day standard will minimize this problem for employees and reduce the fiscal impact on states.

Conclusion

Maintenance of a federal system in which states have the authority to design their own tax systems will necessarily impose higher compliance burdens on individuals and their employers than a unitary system with a single tax regime. State tax administrators are not unmindful of the need to consider these compliance burdens and to balance them against the objectives of maintaining state tax sovereignty and not disrupting revenue flows. Tax administrators are committed to exploring options to address the burden of the current withholding and tax liability rules for persons temporarily employed in a state.

FTA believes that H.R. 1864 as introduced does not appropriately balance the interests in this debate. It goes well beyond what is necessary to address legitimate issues of certainty, simplification and compliance and does real harm to state tax systems. To a considerable degree, the harm and exposure to state tax systems is caused by the legislations inadequate record keeping provisions, the excessive 30-day threshold contained in the bill, and the lack of an income-denominated component to the threshold for determining when individuals are liable for taxes in a state in which they have worked temporarily. We look forward to working with the Committee to address these and the other issues we have outlined should you so desire.

Thank you Mr. Chairman. That concludes my testimony.