

**Multistate Tax Commission Policy Statement 02-02**  
**Amended October 17, 2002**

**02-02        Ensuring the Equity, Integrity and Viability of State  
Income Tax Systems**

**2.1 Preamble**

The right of a state to tax a fair share of interstate commerce that occurs within its borders is an essential element of sovereignty guaranteed under the U.S. Constitution. The exercise of that right by a state is fundamental to the proper allocation of the costs of governmental services to those who benefit from those services, which includes in-state residents and businesses and out-of-state enterprises engaging in business within the state. Otherwise, in-state residents and businesses will be unfairly burdened by the cost of services attributable to economic activity of out-of-state enterprises.

A primary means by which states tax a share of interstate commerce is by taxing income earned within its borders. To be fair to all taxpayers income should be properly measured and divided among states in reasonable relationship to where the income was earned. Businesses earn income by engaging in activities of supply that meet customer demand. Engaging in either supply or demand activities beyond *de minimis* levels is evidence that the enterprise is doing business within a state, earning income within its borders and benefiting from the opportunities and services provided by that state.

Unfortunately, in recent years the increasing use of business tax sheltering methods has significantly undermined the proper accountability of income reporting by many multistate enterprises that are both willing and able to engage in aggressive tax avoidance. The extensive use of business tax shelters undermines the equity, integrity and viability of state income tax systems. Federal proposals to restrict state authority to impose business activity taxes will serve to legalize and expand tax shelter opportunities for a large segment of multistate businesses and further shift the tax burden unfairly to local citizens and businesses.

The recent rise in business tax sheltering compounds long-standing problems of ensuring proper accountability of income reporting from multinational corporations. In 1990, a congressional subcommittee estimated that the federal government lost \$30 billion annually due to widespread international transfer pricing practices that shift income earned in the United States to tax haven locations. That \$30 billion in lost federal revenue translates into approximately \$6 billion of additional revenue lost at the state level. Federal

efforts to solve the transfer pricing and other international income shifting problems have been ineffective.

Widespread international and domestic tax sheltering adversely affects the economy. Earning statements that are inflated by unproven tax shelters mislead investors as to the true value of a corporation's actual business activity. Capital is misallocated away from prudent enterprises that are diligent in their tax reporting obligations and toward corporations that engage in risky tax planning methods. Recent spectacular corporate bankruptcies underscore the fact that some companies that engage in aggressive tax planning methods only postpone the inevitable day of economic reckoning and, in the process, harm both investors and employees. Beyond the problems of tax equity, improper reporting of income for tax purposes creates significant economic harm.

The Multistate Tax Compact charges the Commission with facilitating "the proper determination of the state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases . . ." The Compact was developed to preserve the sovereign authority of states to tax a fair share of interstate commerce occurring within their borders. Accordingly, the Commission by law and history is committed to advancing the full accountability of income reporting in reasonable relationship to where income is earned. A major portion of the activities of the Commission and its member states is devoted to this purpose. The Commission urges Congress and the Administration to support the states in achieving that purpose and, at a minimum, refrain from any actions that further undermine the equity, integrity and viability of state income tax systems.