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BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

H.R. 1956

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BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005

TUESDAY, SEPTEMBER 27, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 1:05 p.m., in Room 2141, Rayburn House Office Building, the Honorable Steve Chabot [Member of the Subcommittee] presiding.

Mr. CHABOT [presiding]. The Committee will come to order. Good afternoon, ladies and gentleman. This hearing of the Subcommittee on Commercial and Administrative Law will come to order. I am not Chris Cannon, I am Congressman Steve Chabot. I am actually the Chair of the Subcommittee on the Constitution of the Judiciary Committee.

Chairman Cannon regrets that he will be unable to be here this afternoon. The Ranking Member, Mel Watt from North Carolina, is unable to be here. So his shoes will be filled, and I am sure quite ably by the gentleman from Massachusetts, Mr. Delahunt, as well. So he and I will try not to screw this up too badly in the absence of our colleagues.

Mr. DELAHUNT. We have the capacity to do that.

Mr. CHABOT. I can only speak for myself. I can't speak for Bill here.

But today we will consider H.R. 1956, the "Business Activity Tax Simplification Act of 2005," a measure intended to provide greater clarity for businesses navigating the tax landscape. This bill was introduced by the gentleman from Virginia, Congressman Goodlatte, on April 28th of this year, and it already has 28 cosponsors.

H.R. 1956 is designed to address a fundamental problem related to interstate commerce. Specifically, when is a State justified in taxing a business with little or no physical connection with that State. Congress has examined this issue from time to time over the years. Recently, with the emergence of the Internet economy, and the explosion of service industries, the need for clear, concise taxation standards has become even more urgent.

In 1959, Congress enacted Public Law 86–272, still in force today, prohibiting States from imposing a business activity tax on companies whose only contact with the State is the solicitation of orders for tangible goods.

But those were simpler days. Since 1959, the economy has been reshaped dramatically. The emergence of the Internet has served

as a major catalyst of this transformation. Companies offer not only tangible goods, but intangible property and services to customers across the country.

But because Public Law 86–272 does not address intangible goods, the law falls short in addressing the current tax landscape. In addition, since 1959, many States appear to have engaged in practices that are at odds with the meaning and intent of Public Law 86–272.

For example, States have begun to impose a tax on a company's business activities on gross receipts rather than on net income. These developments have wreaked havoc on businesses. These businesses have incurred great expense in attempting to decipher and in many cases litigating the appropriate nexus standard for business activity taxes.

H.R. 1956 would provide some certainty to this issue. It would amend Public Law 86–272 to apply to solicitation activities in connection with all sales, not just sales of tangible personal property. It would also cover all business activity taxes, not just net income taxes.

It establishes a brightline 21-day physical presence requirement for the imposition of business activity taxes and would codify the current physical presence standard observed for years and elaborated by the Supreme Court in 1992 in *Quill v. North Dakota*. In *Quill*, the Court required that in order for a State to impose a requirement that remote vendors collect and remit sales taxes for sales made to customers in the State, the business must have a physical presence within the State.

During the 107th and 108th Congresses, the Subcommittee considered similar measures also sponsored by our colleague, Mr. Goodlatte. The bill in the 107th Congress was reported out favorably by this Subcommittee, though the full Judiciary Committee did not have an opportunity to consider it prior to conclusion of that Congress.

In the 108th Congress, this Subcommittee did not have an opportunity to consider the bill further after a legislative hearing, examining the issues in the bill. Seeking certainty amidst the confusion, numerous business associations have expressed their strong support for H.R. 1956, including the National Retail Federation, the National Association of Manufacturers, the Motion Picture Association of America, Inc., and the Software and Information Industry Association, to name only a few.

In considering this legislation, Congress recognizes its responsibility under the U.S. Constitution to ensure that States do not unduly burden interstate commerce through the use of their taxing authority. We also seek to promote a legally certain and stable business environment that will encourage businesses to make investments. At the same time, we endeavor to do so without detracting from reasonable concepts of State and local taxing prerogatives.

I look forward, as I know all the Members of this panel do, to the testimony of our highly informed panel before us here this afternoon. I ask unanimous consent that Members have 5 legislative days to submit written statements for inclusion in today's record.

I would now yield to the gentleman from Massachusetts, Mr. Delahunt, to make an opening statement.

Mr. DELAHUNT. Yes. Thank you, Mr. Chairman.

As you indicated, Mr. Watt, who is the Ranking Member of this particular Subcommittee, is unavailable because today he is in Haiti at the invitation of the Secretary of State.

But I do speak for him when I say we believe this bill addresses very important, interesting and complex issues, and appreciate the opportunity for us to create a complete comprehensive and balanced record of the competing views of the various stakeholders.

We have held hearings on prior iterations of this legislation. Yet, in the past few months, we have heard perspectives that have not been presented to this Subcommittee previously. Knotty policy choices and real-life implications are associated with this legislation.

The Supreme Court seeks to overturn any Congressional legislation that urges us to expand. State and local legislatures advance sound Federalism and tax policy arguments against BATSA. They argue that in a borderless economy States must have flexibility to tax economic activity that generates millions in income for otherwise absent corporations. They further contend that the bill would undermine the ability of State and local governments to attract jobs and investment and would incentivise businesses to establish corporate structures that avoid legitimate taxation.

The business community as a whole argues that State and local governments are abusing their power to tax and are systematically imposing multiple and discriminatory taxes on minimal activity within their borders. Subsets of the business community, service industry, retailers, financial institutions and others present specific, distinct and equally persuasive arguments in favor of the so-called brightline physical presence test.

Finally, organizations like the Council on State Taxation support the enactment of the so-called physical presence nexus standard but only as a quid pro quo for enhanced State authority to require remote sellers of tangible goods to collect and remit sales taxes. This issue has been the subject of special legislation in the past, filed by myself. We believe that we must continue to consider carefully the implications of this bill.

One thing is very clear to us, we must strike a very delicate balance, particularly in face of mounting unfunded mandates to ensure that State and local governments are not unfairly stripped of legitimate revenue to perform their traditional governmental functions, and that business entities are not unjustly strapped with illegitimate taxes that could weaken our overall economy. We hope the focus of this hearing and future hearings will be on determining where that delicate balance should be.

Thank you, Mr. Chairman, and I thank the witnesses in advance of their contribution to this debate. On behalf of Mr. Watt, I express his regret for not being able to be in attendance here today, albeit, I would suggest, for an excellent reason.

Mr. CHABOT. Thank you very much. I appreciate your opening statement. Does the gentleman from North Carolina, Mr. Coble, like to make an opening statement?

Mr. COBLE. Very briefly, Mr. Chairman, I will say that Chairman Cannon and Ranking Member Watt have been replaced by superb substitutes.

Mr. DELAHUNT. We agree.

Mr. CHABOT. Take as much time as you like, Mr. Coble.

Mr. COBLE. I figured that would get me additional time. This bill addresses a nagging problem that needs to be resolved. I oftentimes wonder, Mr. Chairman and Mr. Delahunt, if the disagreement is whether or not a substantial nexus has been established, A, or, B, whether anyone doing business in a State should be taxed. I think our good revenue collectors—I used to be one, Madam, so I can say that—we want to get our hands on every dime that is not nailed down. Then there are other folks who believe that no one should be taxed. Clearly those two extreme groups, I think, do not resolve the problem.

Mr. Chairman, I look forward—I need to go to another hearing, but I look forward to as much of this hearing as I can be able to be here for.

Thank you, Mr. Chairman.

Mr. CHABOT. Thank you, Mr. Coble. We especially appreciate the first part of your statement. Mr. Franks, the gentleman from Arizona, is recognized if he would like to make an opening statement.

Mr. FRANKS. Mr. Chairman, I think Mr. Coble pretty much expressed my sentiments, so we will go with that.

Mr. CHABOT. Thank you very much. I appreciate your comments and attendance. The Chair notes and welcomes the presence on the dais of the gentleman from Virginia, Mr. Goodlatte. Although not a Member of the Subcommittee he is a Member of the full Judiciary Committee, and he is the sponsor of the legislation which we are dealing with here this afternoon.

Mr. Goodlatte, we welcome you and are grateful for your continuing efforts. As many of you know, Mr. Goodlatte is also the Chairman of the Agricultural Committee, so he is a very powerful Member of the United States House of Representatives. The Chair will exercise its discretion in this instance and would recognize Mr. Goodlatte for a few minutes for any remarks that he might like to make.

Mr. Goodlatte.

Mr. GOODLATTE. Mr. Chairman, thank you very much for scheduling this hearing on the Business Activity Tax Simplification Act. I introduced this legislation with my good friend Rick Boucher of Virginia to provide a brightline of State and local authority to collect business activity taxes from out-of-State entities. Many States and local governments levy corporate income, franchise and other taxes on out-of-State companies that conduct business activities within their jurisdictions. While providing revenue for States, these taxes also serve to pay for the privilege of doing business in a State.

However, with the growth of the Internet, companies are increasingly able to conduct transactions without the constraint of geopolitical boundaries. The growth of the high tech industry industry and interstate business-to-business and consumer transactions raises questions over whether multistate companies should be required to pay corporate income and other business activity taxes.

Over the past several years, a growing number of jurisdictions have sought to collect business activity taxes from businesses located in other States, even though those businesses receive no appreciable benefits from the taxing jurisdiction, and even though the Supreme Court has ruled that the Constitution prohibits a State from imposing taxes on businesses that lack substantial connections to the State.

This has led to unfairness and uncertainty, generated contentious, widespread litigation and hindered business expansion as businesses shy away from expanding their presence in other States for fear of exposure to unfair tax burdens.

In order for businesses to continue to become more efficient and expand the scope of their goods and services, it is imperative that clear and easily navigable rules be set forth regarding when an out-of-State business is obliged to pay business activity taxes to a State. Otherwise, the confusion surrounding these taxes will have a chilling effect on e-commerce, interstage commerce generally and the entire economy as tax burdens, compliance costs and litigation and uncertainty escalate. Previous actions by the Supreme Court and Congress have laid the groundwork for a clear, concise and modern brightline rule in this area.

In the landmark case of *Quill Corporation v. North Dakota*, the Supreme Court declared that a State cannot impose a tax on an out-of-State business unless that business has a substantial nexus with the taxing State. However, the Court did not define what constituted a substantial nexus for the purposes of imposing business activity taxes.

In addition, over 40 years ago Congress passed legislation to prohibit jurisdiction from taxing the income of out-of-State corporations whose in-State presence was nominal. Public Law 86–272 set clear uniform standards for when States could and could not impose such taxes on out-of-State businesses when the business's activities involve the solicitation of orders for sales.

However, like the economy of its time, the scope of Public Law 86–272 was limited to tangible personal property. Our Nation's economy has changed dramatically over the past 40 years, and this outdated statute needs to be modernized. The Business Activity Tax Simplification Act both modernizes and provides clarity in an outdated and ambiguous tax environment.

First, the legislation updates the protection of Public Law 86–272. This legislation reflects the changing nature of our economy by expanding the scope of the protections in 86–272 from just tangible personal property to include intangible property in all types of services. In addition, our legislation sets forth clear, specific standards to govern when businesses should be obliged to pay business activity taxes to a State. Specifically the legislation establishes a physical presence test, such that an out-of-State company must have a physical presence in a State before the State can impose franchise taxes, business license taxes and other business activity taxes.

The clarity that the Business Activity Tax Simplification Act will bring will ensure fairness, minimize litigation and create the kind of legally, certain and stable climate that encourages businesses to make investments, expand interstate commerce, grow the economy

and create new jobs. At the same time, this legislation will protect the ability of States to ensure that they are fairly compensated when they do provide services to businesses that do have a physical presence in their State.

Again, Mr. Chairman, thank you for holding this important hearing.

Mr. CHABOT. Thank you very much. Before I begin with witness introductions, I ask unanimous consent that the record will remain open for 5 legislative days for other interested parties to submit statements for inclusion in the hearing record.

Also, we have a number of statements from interested parties on all sides of this issue that I would like to have submitted for the record. I would ask unanimous consent to enter these statements into the record.

Hearing no objection, these statements will be entered into the record.

Now I would like to introduce our very distinguished panel here this afternoon.

Our first witness is Bo Horne, the President of ProHelp Systems, Inc., a software development company located in Seneca, South Carolina. A graduate of the Georgia Institute of Technology with a degree in electrical engineering, Mr. Horne founded ProHelp Systems, Inc. in 1984. ProHelp designs, develops and markets highly complex and specialized product configuration, engineering and manufacturing software systems for electrical equipment manufacturers and creates systems integration software for mid-range and mainframe markets.

Mr. Horne, thank you again for your appearance here today. We look forward to your testimony in just a couple of minutes here.

The next witness is Earl Ehrhart, State Representative for the 36th House District of the State of Georgia.

Mr. Ehrhart has served in the Georgia House of Representatives since his first election in 1988. He is Chairman of the House Rules Committee and a Member of the Appropriations, Banking and State Institutions and Public Property Committees, and we welcome you here this afternoon, Mr. Ehrhart.

You currently serve as the national chairman of the American Legislative Exchange Council, a nationwide bipartisan group of legislators. In recognition for his leadership, he has been honored with a Champion of the Free Enterprise System Award from the Associated Builders and Contractors of Georgia, and he has been the recipient of the Guardian of Small Business Award by the National Federation of Independent Business. Mr. Ehrhart earned his Bachelor's Degree from the University of Georgia.

When not serving in the legislature, he is the Senior Vice President of the Facility Group, Inc., an architectural and engineering firm. Mr. Ehrhart, we congratulate you for your substantial efforts and look forward to your testimony from a State perspective here this afternoon.

Our next witness will be Joan Wagnon, Secretary of Revenue of the State of Kansas. Ms. Wagnon was appointed to her current position in 2001. Secretary Wagnon is a former six-term State legislator representing Topeka in the Kansas House from 1983 to 1994. She also was elected as the Mayor of Topeka in 1997 and served

until 2001. Secretary Wagnon is the Chairman of the Multistate Tax Commission, as well as the Chair of the Midwestern States Association of Tax Administrators. She is also a member of the Federation of Tax Administrators board of directors and is actively involved in several charitable organizations, including the national board of the Girl Scouts U.S.A., the Midland Hospice of Topeka and the Downtown Rotary Club.

Secretary Wagnon earned her Bachelor's Degree from Hendrix College in Arkansas and her Master's of Education in guidance and counseling from the University of Missouri.

Secretary Wagnon, welcome, we appreciate your testimony here this afternoon.

Our final witness is Lyndon Williams, Tax Counsel for Citigroup, Incorporated. Mr. Williams is responsible for providing advice and counsel on matters relating to the various aspects of tax law, including State and local taxation. He represents Citigroup as global e-commerce tax counsel, working with the Organization for Economic Cooperation and Development on tax policy matters involving international taxation. He is also a member of the tax committees of the Business and Industry Advisory Committee to the OECD and the United States Council for International Business.

Mr. Williams earned a Bachelor's Degree in business administration, majoring in accounting, from Baruch College at the City University of New York. He received his Master's of Science Degree in taxation from Pace University Graduate School of Business in White Plains, New York and his law degree from Pace Law School. Mr. Williams is a member of the New York State Bar Association and the President of the Association of Black Lawyers of Westchester County.

Mr. Williams, thank you very much for your appearance here this afternoon as well.

We extend to each of you the warm regards and appreciation for your willingness to participate in today's hearings.

In light of the fact that your written statements will be included in the hearing record, we would request that you limit your remarks, if at all possible, to 5 minutes.

You will note that we do have a lighting system up there. During the first 4 minutes of the 5 minutes, there will be a green light on. When you have 1 minute to go the yellow light will come on, and the red light means that you are supposed to wrap up.

Chairman Cannon's practice has been to tap the gavel at 5 minutes so you will know that your time is up, and we won't gavel you down at that time but we would appreciate it if you would wrap it up close to that time if at all possible.

Pursuant to the directive of the Chairman of the Judiciary Committee, I ask that the witnesses please stand because it is the practice of the Committee to swear in all witnesses before the Committee.

[Witnesses sworn.]

Mr. CHABOT. Let the record reflect that each of the witnesses answered in the affirmative, and you may all be seated.

Mr. Horne, at this time you are recognized for 5 minutes.

TESTIMONY OF CAREY J. "BO" HORNE, PRESIDENT, PROHELP SYSTEMS, INC.

Mr. HORNE. Thank you, Mr. Chairman.

Mr. CHABOT. If you could turn that on. If you would pull the mike a little closer to you there. Thank you.

Mr. HORNE. I am new at this.

Mr. CHABOT. Okay.

Mr. HORNE. Thank you, Mr. Chairman, and Members of the Subcommittee for this opportunity to support H.R. 1956, the Business Activity Simplification Act. I am Bo Horne, President of ProHelp Systems, a home-based software business in South Carolina. It is an honor being asked to address an issue so vital to small business. I represent no one but my wife, myself and our small business. We are here today at personal expense to plead for your support for a bill which clarifies the reasonable physical presence standard must be applied when determining nexus for interstate activity.

Our experience clearly shows what happens when the standard leaves the smallest avenue open to abuse by greedy States. Our many conversations with people across this country also shows such abuses are far more common than generally recognized. Without strong Federal legislation, small businesses will soon be unable to participate in interstate commerce. We are speaking up because thousands of small businesses are totally unaware of today's risks.

In 1997, we sold one copy of our licensed software to a customer in New Jersey for $695. Because of this single sale, the State of New Jersey now demands that we pay $600 in taxes and fees every year the software remains in use, even in years with no sales, and regardless of any profit. Despite 2 years of effort and substantial legal fees, New Jersey continues to press its claim. Should all 50 States adopt New Jersey's corporate business tax, small software developers selling just one license in every State would owe $30,000 in business activity taxes every year thereafter even with no additional sales anywhere. Should localities follow suit the results would truly be astronomical. These are powerful reasons to stay out of the software business.

We have little idea where our customers reside, but we are proud to have sold software in 32 countries. We have less than $30,000 per year in domestic sales of licensed software. How can we provide jobs or even remain in this business if State taxes exceed total sales?

The issue is not limited to software. New Jersey even defies protections of the Interstate Income Tax Act of 1959, which prevents States from imposing 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 will be subjected to the same tax.

Ours is not an isolated case. We are personally aware of small business victims in multiple States, including three represented on this Subcommittee, North Carolina, Wisconsin and Virginia. We did not search for these victims. Desperate for help, they found us from testimony we submitted to this Subcommittee last year or from numerous articles written about our case. Each of you should understand that small businesses in your own State are already being wrongfully burdened by greedy States.

The nightmares are certain to escalate. New Jersey increased its minimum tax 150 percent in 2002. This tax is 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.

Why should anyone believe this tax will not soon be increased again and spread to other States? Without clear protection 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. No small business can possibly cope with the widely varying and ever-changing laws of 50 States, the administrative burdens of keeping records by State, or the costs of preparing and filing multiple returns, nor can we afford to pay inflated tax claims or legal fees required to defend against them.

If Smithfield Foods has difficulty complying with State tax laws, as Tracy Vernon testified last year, how can small businesses ever do so? Many small businesses are not yet vocal with their support for this legislation. Most have no idea they may be involved in nexus issues or even what nexus means. They are totally unaware that many States will attempt to tax their activities. But as information tracking systems become more powerful and pervasive and as the Internet changes the very foundations of interstate commerce, small business will be trapped like a deer in headlights, totally defenseless against what is certain to happen, unless Congress uses its authority to protect us.

Mr. Chairman, I would love to continue explaining why small businesses desperately need your help. My time is up, and I have provided more in writing, so I will close with one thought. The growing constraints on our participation in interstate commerce will ultimately impose economic costs our country simply cannot afford. Please act on this bill before more damage occurs.

Again, it has been an honor to speak to you and I will be happy to answer questions.

[The prepared statement of Mr. Horne follows:]

PREPARED STATEMENT OF CAREY J. (BO) HORNE

Thank you Mr. Chairman, Ranking Member Watt, and members of the Subcommittee for this opportunity to support H.R. 1956, the Business Activity Tax Simplification Act. I am Bo Horne, President of ProHelp Systems, a home-based software business in South Carolina. It is an honor being asked to address an issue so vital to small business.

I represent no one but my wife, myself, and our small business. We are here today at personal expense to plead for your support for a bill which clarifies that a reasonable physical presence standard must be applied when determining nexus for Interstate activity. Our experience clearly shows what happens when the standard leaves the smallest avenue open to abuse by greedy States. Our many conversations with people across the Country also show such abuses are far more common than generally recognized. Without strong Federal legislation, small businesses will soon be unable to participate in Interstate Commerce. We are speaking up because thousands of small businesses are totally unaware of the risks.

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The abuse is not limited to software. New Jersey even defies protections of the Interstate Income Tax Act of 1959 (P.L. 86–272), which prevents States from imposing 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 will be subjected to the same tax.

Ours is not an isolated case. We are personally aware of small business victims in multiple States, including three represented on this Subcommittee: North Carolina, Wisconsin, and Virginia. We did not search for these victims. Desperate for help, they found us from testimony we submitted to this Subcommittee last year or from numerous articles written about our case. Each of you should understand that small businesses in your own State are already being wrongly burdened by greedy States.

The nightmares are certain to escalate. New Jersey increased its minimum tax 150% in 2002. This tax is 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. Why should anyone believe this tax will not soon be increased again, and spread to other States? 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.

No small business can possibly cope with the widely varying and ever changing laws of 50 States, the administrative burdens of keeping records by State, or the costs of preparing and filing multiple returns. Nor can we afford to pay inflated tax claims or legal fees required to defend against them. If Smithfield Foods has difficulty complying with State tax laws, as Tracy Vernon testified last year, how can small businesses ever do so?

Many small businesses are not yet vocal with their support for this legislation. Most have no idea they may be involved in nexus issues or what nexus even means. They are totally unaware that many States will attempt to tax their activities. But, as information tracking systems become more powerful and pervasive, and as the Internet changes the very foundations of Interstate Commerce, small business will be trapped like a deer in headlights, totally defenseless against what is certain to happen, unless Congress uses its authority to protect us.

Mr. Chairman, I would love to continue explaining why small businesses desperately need your help. My time is up, and I have provided more in writing; so I will close with one thought.

The growing constraints on our participation in Interstate Commerce will ultimately impose economic costs our Country simply cannot afford. Please act on this bill before more damage occurs.

Again, it's been an honor to speak to you; and I will be happy to answer questions.

ADDITIONAL INFORMATION

One very positive aspect of our saga has been the realization that our representative democracy works far better than we have been led to believe. We have been treated with courtesy, respect, and great empathy by the hundreds of representatives, state and federal officials, attorneys, businessmen, news editors, and private citizens we have spoken with about our ordeal. Without their enormous support and encouragement, we simply would not be here today.

All of our Company's work is performed in our home, we are the only employees (though we have had additional employees in prior years), and our company is our sole source of earned income. Our company is incorporated in Georgia and registered in Georgia and South Carolina. We have elected S Corporation status, operate and pay taxes as such, and file appropriate returns in Georgia and South Carolina each year. We pay employment taxes to South Carolina, and we acknowledge nexus in both Georgia and South Carolina. All work is conducted in South Carolina via the telephone, the Internet, and the U. S. Postal Service.

The State of New Jersey is asserting a claim of nexus against our company due to the sale of seven intangible software licenses during the period 1997–2002. During this period, we generated total revenue from New Jersey-based customers of $6,132. By year, our sales into New Jersey for that period were $695, $0, $0, $0, $49, and $5388, respectively. Those are single dollars, not $K, $M, or $B. Of this total, $5,133 was derived from the actual license sales and $999 from additional services performed in South Carolina after the original sales.

New Jersey acknowledges that its **original** claim of nexus was based **solely** on the existence of these seven software licenses within the state. New Jersey's claim of nexus will be made as long as any licenses remain in use within the State, even if we cease accepting all business from New Jersey customers and generate zero future income from sales into the State. It is important to note there is nothing special about our license; it is very similar to ones provided with shrink-wrapped software commonly available at electronics or office supply stores such as Best Buy or Staples.

New Jersey's claim of nexus generates a requirement for our company to pay $500 per year as the New Jersey **minimum** corporate tax and $100 per year for Corporate Registration fee, **every year,** even in years when we have zero sales in New Jersey and have no other business activity in the State. (If not for the minimum corporate tax and registration fee, **our calculated tax would be less than $1.00 in our best year**.)

We have been advised by the New Jersey Division of Taxation that the only way to remove our **future** liability for paying this $600 per year in tax and fees is to:

(1) stop accepting all orders from New Jersey,

(2) have zero New Jersey income,

(3) terminate all existing software licenses, and

(4) have our customers remove all licensed software from their systems. We have been advised that we **cannot** terminate our nexus in future years by abandoning our license agreements and giving clear title of the software to our customers.

We have met these requirements, as of December 31, 2003, through the following actions:

- We have terminated **all** of our national advertising. Our sales are down significantly as we attempt to refocus our activity into Georgia and South Carolina only.
- We have stopped accepting **all** orders from New Jersey locations. **We cannot accept any business, of any type, from New Jersey locations until small business is given the protection it must have in order to participate in Interstate Commerce on a free and unhindered basis.** In January 2004, we refused to accept a firm order for $15,000 of remote services from a Georgia customer who would have made payment through a New Jersey office. The risk of validating their claims of nexus **in future years** was simply too great for us to accept. Needless to say, this decision hurt our business badly.
- We have terminated all software licenses in New Jersey, and our customers have removed all licensed software and replaced it with new, unlicensed software. As a result, our intellectual property no longer receives the protection it must have in order to insure its viability for future enhancements and improvements and for our future income.

These actions have combined to significantly reduce and inhibit our participation in Interstate Commerce, reduce our sales, reduce our personal salaries, and reduce our payments of badly needed Federal and South Carolina tax revenues. We have become so concerned about the risk of our continued participation in Interstate Commerce that we are asking ourselves: "Why bother? Can we afford the risk? Should we terminate the business before it gets worse?"

Our situation, and that of all small businesses participating in Interstate Commerce, is simply intolerable. Had we sold just one $695 license in 1997 and not derived any further income from New Jersey customers, we would still be subject to the requirement of paying $600 per year in New Jersey taxes and fees as long as our customer continues to use the license. To fight this horribly unjust taxation, we have been forced to spend thousands of dollars in legal fees to defend ourselves; and we are continually distracted from pursuing our normal business activities which generate all of our earned income.

Making the situation even worse, **New Jersey has since expanded its regulations to assert nexus** ***against all companies deriving any type of income***

from New Jersey customers, regardless of physical presence or *de minimis* activity. This latest provision of New Jersey tax regulations includes the sale of tangible products and is in direct defiance of Congressional intent and the physical presence standard of Public Law 86–272. Should all 50 states adopt these same provisions, the sale of a single box of paper clips in each state, at any point in time, would generate the requirement to file a state tax return in every State and to pay **$30,000** in minimum taxes and fees per year, forever, even in years when no sales are made in those states, unless crucial steps are taken promptly to terminate nexus. And, New Jersey does not make that termination easy.

More importantly, no company can survive by continually paying taxes on zero profits or by paying taxes greater than total sales. After our total sales are reduced by amounts not related to licensed software, by amounts for services, and by international sales, we have less than $30,000 in total domestic sales of licensed software. How can we develop, market, support products, and provide jobs, or even remain in this business, under those circumstances?

New Jersey is not the only State adopting highly aggressive tactics which threaten small businesses. Such tactics are becoming more prevalent each year, and BATSA will stop the abuses. BATSA is simply vital for protecting small businesses by clearly codifying numerous existing judicial precedents and Congressional intent inherent in Public Law 86–272 and by providing a uniform and bright-line standard of physical presence for nexus.

We realize there are multiple sides to every issue; for BATSA, there are at least three:

- **Small businesses:** Hopefully, we are sufficiently conveying why the passage of BATSA is so absolutely critical if small businesses are to participate in Interstate Commerce.
- **Large businesses:** Having worked for and with large businesses for many years, we understand and support their need for clarity and simplification of the rules which would allow them to devote more attention to delivering products and services instead of defending themselves in legal actions.
- **The States:** Why are they so strongly resisting BATSA?

(a) We totally reject their claims of State sovereignty. Our Founding Fathers, who created the best form of government our world has known, wisely understood that Federal regulation would be vital toward assuring a vibrant National economy and gave the Congress broad powers to regulate Interstate Commerce. They included the Commerce Clause to cure a problem that had *already* occurred during the Colonial period. It is the *exact* problem small businesses face today: greedy States, totally unconcerned about the National economy. The Commerce Clause gives this Congress very clear and absolute authority to regulate this critical area of our economy. Without question, Congress has absolute jurisdiction to protect the rights of hundreds of thousands of small businesses attempting to participate in Interstate Commerce, free from undue burdens associated with paying taxes in multiple States; and the States ceded all rights for any claims of sovereignty over this issue when they joined the Union.

(b) We also reject their wildly exaggerated claims of lost revenues. Several analyses have been made, but has a single one ever factored in the loss of hundreds of thousands of jobs, perhaps millions, because small businesses cannot safely participate in Interstate Commerce? We can guarantee that tax revenues obtained from small businesses will begin declining soon, and many jobs will be lost, unless our problem is corrected now. No small businessman, once he understands the risks involved, will dare participate in Interstate Commerce.

The distribution of taxable income may change among the States, but it should. We do all work from our home; *all* of our economic activity occurs there. Shouldn't we pay *all* our taxes to South Carolina? Shouldn't this apply equally to large businesses with no physical presence in a State? If a State's revenue drops due to passage of this bill, it is because the State is already engaging in unfair tactics; **and its revenue should and must drop.** *Many States are already losing a portion of their own legitimate tax revenues to the greedy States.*

(c) A possible threat to States' revenues arises from the **improper** use of intangible holding companies. If an intangible holding company licenses intangible property to an unrelated company, then it **should** receive the protection the physical presence standard provides. If the intangible holding company operates only to avoid taxation, without other legitimate

business purposes, the States have several remedies they have traditionally employed to prevent loss of income; and many States have already enacted one or more of them. So, this issue is no reason to avoid prompt passage of this bill.

New Jersey is targeting numerous small businesses which sell to Casinos and therefore must be registered (by the Casino, not the small business) with the Casino Control Commission (CCC). The CCC even sends registrants a letter clearly indicating they don't have to do anything else unless they sell more than $75,000 to a single casino in a single year. No mention is made of any State requirement to file or pay income taxes simply because an Interstate sale has been made. We even called, *twice,* to verify there were no additional steps for us to take. New Jersey is also using all other possible types of such independent registrations to pursue small Interstate businesses.

Further, and it is a matter of public record, Governor McGreevey of New Jersey was asked by the media during the signing ceremony for its CBT tax increase about the effect the tax would have on small businesses. The Governor indicated that New Jersey would not be going after small businesses. It is now clear that he had little or no control over his State agencies, was mistaken, or simply lied about what was soon to begin. New Jersey has thus violated basic requirements of Due Process and is at least guilty of the entrapment of many small businesses.

Many scholars and tax experts believe the Supreme Court has spoken very clearly in numerous decisions regarding Interstate nexus issues and the Congress has spoken very clearly with the physical presence standard in Public Law 86–272. Given the problems so obvious today, how can anyone justify not providing total clarity for *all* sales? How can anyone justify our paying any tax to any State except South Carolina or Georgia, where all of our economic activity occurs?

Customers in other States occasionally seek to buy our products because similar products are not available in their own State, ours are superior for their needs, or ours are less costly. Customers buying our products actually save money by doing so, thereby increasing their own profits and their own tax obligations within their own States. New Jersey has provided no services to our Company. We have not attempted to market explicitly to customers in New Jersey. To the contrary, customers in New Jersey came to us because our products provide some advantage to them. Why should such a purchase create a new tax obligation for our Company? The Congress is going to great lengths to promote free international trade while this horrible situation restrains trade within our own borders.

As a private citizen and small businessman, I have concluded the passage of BATSA is the **fair and right thing to do** for all business, both large and small, that it is vital for protecting small businesses, that it is vital for protecting jobs and our economy, that States' claims of various harms are ill-advised and simply not true, and that all sales should be treated equally as intended by the Congress when it passed Public Law 86–272. Otherwise, very large portions of our economy (i.e., intellectual property, remote services, and small businesses in particular) become highly disadvantaged in their conduct of Interstate marketing activity.

Because physical presence was intended to be the current standard, BATSA would neither diminish the taxing powers of state and local jurisdictions nor reduce state and local tax revenues. It will allow businesses to concentrate on growing our economy and providing jobs, instead of arguing legal points at great cost, by ensuring no undue burdens hinder Interstate Commerce.

We beg for your support and prompt passage of this bill, on behalf of the thousands of small business owners nationwide whose economic futures rely on it, and on behalf of continued strength in our National economy.

Mr. CHABOT. Thank you very much, Mr. Horne.

Representative Ehrhart is recognized for 5 minutes.

TESTIMONY OF EARL EHRHART, STATE REPRESENTATIVE, GEORGIA HOUSE OF REPRESENTATIVES, 36TH DISTRICT, NATIONAL CHAIRMAN OF THE AMERICAN LEGISLATIVE EXCHANGE COUNCIL

Mr. EHRHART. Thank you, Mr. Chairman and Members of the Committee. I also found the Chairman and Ranking Member comments edifying as to my time.

My name is Earl Ehrhart. I am a State Representative in Georgia, where I chair the Georgia House Rules Committee. I also serve, as you noted, as the ALEC national Chair.

The American Legislative Exchange Council is the Nation's largest bipartisan individual membership organization of State legislators. We have over 2,400 members from all 50 States and 97 members, former members in Congress today.

It is my pleasure to appear before you to present testimony regarding H.R. 1956, the "Business Activity Tax Simplification Act." I was elected in Georgia's 36th District to represents my constituents' interest in Georgia. Part of that responsibility is to ensure that our State develops a business climate that expands opportunities for our existing companies and attracts new business investment.

As a State legislature, however, there's only so much I can do to help develop a solid business climate in Georgia. Many entrepreneurs in Georgia do business all over the United States in our new economy and all over the world. We need the help of Congress to ensure that the Georgia-based companies aren't being unjustifiably taxed by those States in which they have no physical presence. Today we see an increased tendency of lawmakers and revenue officials in other States to get aggressive when it comes to raising of revenue from out-of-State companies. If our State is making that effort to provide an infrastructure to attract and maintain business in our State, we should be the ones to enjoy those same benefits.

If we don't curb this aggressive behavior by other States, we are going to lose our ability to provide a prosperous business environment in Georgia. H.R. 1956, with its physical presence, is a good step toward protecting that same ability. If companies are paying States taxes only where they are physically present, then we can be comfortable knowing that we can attract business to Georgia, give them the services we need, get the taxes we need in return to help pay for those services and hopefully persuade them to reinvest in our State.

I am not the only State lawmaker who holds that view. As I mentioned earlier, I am the chairman, the national chairman of ALEC. ALEC in 2003 approved a model resolution, a resolution on State and local business activity taxes calling on Congress to expand and protect the physical requirement. I have passed out a copy of that for your perusal.

Our resolution states very simply, the physical presence standard promotes fairness by assuring that businesses that receive benefits and protections provided by State and local governments pay their fair share for these services and the ability of State and local jurisdictions to tax out-of-State businesses should be limited to those situations in which the business has employees and/or property in the taxing jurisdiction and accordingly receives meaningful government benefits or protections from that jurisdiction. ALEC supports this approach because it is consistent with our Jeffersonian principles of individual liberty, limited government and free markets, and not without interest, it supports Federalism and not the other way around. States should not be able to tax those companies that are not physically present in their State.

A more expansive approach, called economic presence by some, exposes businesses to more taxes, more litigation, but less money and time to invest and grow the economy. I know some of my colleagues from other organizations, the MTA, have a different opinion about this bill. I would like to take just a moment to address their concerns in particular, tax revenue losses and tax shelters.

You have heard in the past, and we will hear in the future that this legislation, physical presence approach in general, will lead to a substantial revenue loss for States. It has been argued that we should refrain from acting on this bill because States will lose revenue needed to pay for schools, roads, health care and police protection. Just anecdotally, States have a spending problem and not a revenue problem. Beware of these revenue estimates. These estimates are based on assumptions that the State revenue departments can and should be collecting all the taxes from all the corporations they say they should. Since the issue of physical presence is unclear, it is not fair to claim they will lose revenue, merely because they believe corporations should be paying a certain amount of taxes based on their questionable interpretation of the law.

As for tax sheltering, again I respectfully disagree that this bill will make tax sheltering worse. It is important to remember the tax shelter is in the eye of the beholder. The U.S. Constitution certainly isn't a tax shelter. H.R. 1956 is not a tax shelter. I believe the physical presence rule best embodies the presence that we find in our Constitution and our laws. I am baffled by my colleagues' insistence that this bill would only serve to open up our States to more corporate tax sheltering.

Once again, even if my colleagues are right, the States have tools to fight these abusive tax shelters. Sham transactions and those that lack economic substance can certainly be fought even if H.R. 1956 becomes law. Lawmakers in other States, Georgia in particular—we have gotten aggressive with that with addbacks, throwbacks, passive investments, the single factor taxation that we passed last year in Georgia. These are tools that we have to accomplish these goals.

In conclusion, Mr. Chairman, thank you for the opportunity to give the perspective of my constituents, as well as of that ALEC. The American Legislative Exchange Council is supportive of the flexibility that the physical presence requirements as outlined in 1956, and we look forward to working with you in the days and months ahead to enhance our States' business climate through a limited government approach.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Ehrhart follows:]

PREPARED STATEMENT OF THE HONORABLE EARL EHRHART

INTRODUCTION

Good morning Chairman Cannon, Representative Watt and Members of the Committee:

My name is Earl Ehrhart, I am a State Representative in Georgia where I chair the Georgia House Rules Committee. I also serve as the National Chairman of the American Legislative Exchange Council.

The American Legislative Exchange Council (ALEC) is the nation's largest nonpartisan, individual membership organization of state legislators with over 2,400 legislator members from all fifty states and 97 members in the Congress. It is my

pleasure to appear before you to present testimony regarding H.R. 1956, the "Business Activity Tax Simplification Act of 2005."

GEORGIA

I was elected in Georgia's 36th District to represent my constituents' interests in the Georgia General Assembly. Part of that responsibility is to ensure that our state develops a business climate that expands opportunities for our existing companies and attracts new business investment.

As a state legislator, however, there is only so much I can do to help develop a solid business climate in Georgia. Many entrepreneurs in Georgia do business all over the United States and the world. We need the help of Congress to ensure that Georgia-based companies aren't being unjustifiably taxed by those states in which they have no physical presence.

Today, we see an increased tendency of lawmakers and revenue officials in other states to get aggressive when it comes to raising revenue from out-of-state companies. If our state is making the effort to provide an infrastructure to attract and maintain business in our state, we should be the ones to enjoy the benefits.

If we don't curb this aggressive behavior by other states, we are going to lose our ability to provide a prosperous business environment in Georgia. H.R. 1956, with its physical presence requirement, is a good step toward protecting our ability to develop the Georgia business climate my constituents expect me to support in the Georgia General Assembly.

If companies are paying state taxes only where they are physically present, then we can be comfortable knowing that we can attract business to Georgia, give them the services they need, get the taxes we need in return to help pay for those services, and hopefully persuade them to reinvest in our state. If businesses are going to be taxed anywhere they have customers or are making sales, then our efforts to recruit these companies will be in vain. Instead of reinvesting in the Georgia economy they will be paying taxes where they have no physical presence.

This policy is bad for Georgia's economy and bad for my constituents who need those high paying jobs to support their families and to realize their dreams. Let's restore sense and clarity to where our businesses pay their taxes. Simply stated, business should pay taxes where they hold a physical presence.

AMERICAN LEGISLATIVE EXCHANGE COUNCIL RESOLUTION,
STATE AND LOCAL BUSINESS ACTIVITY TAX

I am not the only state lawmaker that holds this view. As I mentioned earlier, I am the National Chairman of the American Legislative Exchange Council, or ALEC. ALEC is a nonpartisan, individual membership organization of over 2,400 state legislators. In 2003, ALEC approved a model resolution, *"Resolution on State and Local Business Activity Taxes,"* calling on Congress to protect and expand the physical presence requirement for the state collection of business activity taxes. I have attached a copy for your perusal. Our resolution states:

> "the physical presence standard promotes fairness by ensuring that businesses that receive benefits and protections provided by state and local governments pay their fair share for these services"; and
>
> "the ability of state and local jurisdictions to tax out-of-state businesses should be limited to those situations in which the business has employees and/or property in the taxing jurisdiction and accordingly receives meaningful governmental benefits or protections from the jurisdiction"

ALEC supports this approach because it is consistent with the Jeffersonian principles of individual liberty, limited government, and free markets. States should not be able to tax those companies that are not physically present in their state.

ECONOMIC PRESENCE—A MODEL FOR DISASTER

A more expansive approach, called economic presence by some, exposes business to more taxes, more litigation, but less money and time to invest and grow the economy. We have been told, through decades of congressional action and court rulings, that interstate commerce is so expansive that it allows Congress to regulate just about any activity in America. I fear for our Georgia-based companies, if the states take the same expansive approach to economic presence. Those of us who advocate a limited government approach, like my colleagues at ALEC, strongly support the physical presence approach to state business taxes.

TAX REVENUE LOSSES AND TAX SHELTERING

I know some of my colleagues from other organizations have a different opinion about this bill. I would like to take just a moment and address their concerns, in particular, tax revenue losses and tax sheltering.

You have heard in the past, and will hear in the future, that this legislation—and the physical presence approach in general—will lead to substantial revenue loss for the states. It has been argued that you should refrain from acting on this bill because states will lose revenue needed to pay for schools, roads, health care, and police protection.

Be wary of these revenue estimates. These estimates are based on assumptions that the state revenue departments can and should be collecting all the taxes from corporations they say they should. Since the issue of physical presence is unclear, it is not fair to claim they will lose revenue merely because they believe corporations should be paying a certain amount of taxes based on their questionable interpretation of the law.

Furthermore, even if my colleagues are correct, and some states do lose tax revenue if this bill becomes law, I say this is as it should be. Corporations should pay taxes only in those states where they are physically present. If my counterparts in other states want to raise more taxes from corporations, they should do so by encouraging them, through lower taxes and other means, to locate in their state, or by raising taxes on their own companies—not by coercing them to pay taxes even when they are not physically present in their state. This is what tax competition is all about.

As for the tax sheltering issue, again, I respectfully disagree with my colleagues that this bill will make tax sheltering worse. It is important to remember that a tax shelter is in the eye of the beholder. The U.S. Constitution is certainly not a tax shelter. H.R. 1956 is not a tax shelter. I believe the physical presence rule best embodies the principles that we find in our Constitution and our laws. I am baffled at my colleagues' insistence that this bill would only serve to open up our states to more corporate tax sheltering.

But once again, even if my colleagues are right, the states have the tools to fight abusive tax shelters. Sham transactions and those that lack economic substance can certainly be fought even if H.R. 1956 becomes law. Furthermore, lawmakers in other states are certainly moving forward with a number of new measures to fight tax shelters, including disallowance of deductions to passive investment companies, addback, and the use of throwback in apportionment. Just this year, Georgia passed an addback amendment in the Georgia House Bill 191. Let me assure you that the arsenals that states have in our battle against tax shelters will remain virtually intact if you pass this bill.

CONCLUSION

Mr. Chairman, thank you for the opportunity to give the perspective of my constituents as well as that of ALEC. The American Legislative Exchange Council is supportive of the flexibility and physical presence requirements as outlined in H.R. 1956. We look forward to working with you in the days and months ahead to enhance states' business climate through a limited government approach.

Thank you. I would be please to answer any questions you might have.

ATTACHMENT

AMERICAN LEGISLATIVE EXCHANGE COUNCIL

A National Association for America's State Legislators • Jeffersonian Principles in Action!

August 2003

A resolution on State and Local Business Activity Taxes

A Resolution

WHEREAS, the United States Supreme Court, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), held that remote sellers lacking a physical presence may not be required to act as tax collection agents of the state; and

WHEREAS, direct state and local taxes on business, also known as "business activity taxes," such as income, franchise, net worth, business license, business and occupation, single business, capital stock, and like taxes, impose an even greater burden on businesses engaged in interstate commerce than an obligation to collect a tax from consumers; and

WHEREAS, the physical presence standard promotes fairness by ensuring that businesses that receive benefits and protections provided by state and local governments pay their fair share for these services; and

WHEREAS, the ability of state and local jurisdictions to tax out-of-state businesses should be limited to those situations in which the business has employees and/or property in the taxing jurisdiction and accordingly receives meaningful governmental benefits or protections from the jurisdiction; and

WHEREAS, the physical presence standard results in the proper attribution of business profits to taxing jurisdictions where a business is located and thus does not result in tax avoidance; and

WHEREAS, a business activity tax filing requirement based on a standard other than physical presence results in increased filing requirements and thus increased compliance costs; and

WHEREAS, businesses currently rely on a physical presence standard for complying with state and local business activity tax obligations, and this standard is applied currently by most state courts; and

WHEREAS, any Congressional authorization for states to impose a sales and use tax collection obligation would further put businesses at risk of the unfair application of business activity taxes by jurisdictions in which the businesses lack a physical presence; and

WHEREAS, the imposition of a standard other than physical presence for business activity taxes would expose U.S. companies lacking a physical presence overseas to similarly expansive and unfair taxation by foreign countries and their provinces; and

WHEREAS, businesses operating in interstate commerce should not be compelled to pay taxes in state and local jurisdictions solely as a result of the business having customers located in the taxing jurisdiction; and

WHEREAS, the United States economy has become more global since Congress first enacted Public Law 86-272 and has shifted toward the provision of more interstate services and intangibles, and providers of services and intangibles are competitively disadvantaged relative to businesses that only sell tangible personal property;

AND WHEREAS, the enactment of new business activity taxes other than income taxes threatens to circumvent the intent of Congress in enacting Public Law 86-272;

NOW, THEREFORE BE IT RESOLVED, That the state of _____ urges Congress to enact legislation 1) recognizing a physical presence standard for the imposition of state and local business activity taxes, 2) defining de minimis standards for measuring physical presence and setting reasonable limits on the attribution of nexus, and 3) updating Public Law 86-272 to extend the current protections available for the solicitation for sales of goods to the solicitation for sales of services and intangibles and to apply these protections to all business activity taxes; and

BE IT FURTHER RESOLVED, That the state of _____ recognizes that any Congressional approval of "sales tax streamlining" without the simultaneous enactment of these business activity tax measures would have a harmful effect on American businesses and the economy.

Mr. CHABOT. Thank you very much.

Secretary Wagnon, you are recognized for 5 minutes.

TESTIMONY OF JOAN WAGNON, SECRETARY OF REVENUE, STATE OF KANSAS, AND CHAIR, MULTISTATE TAX COMMISSION

Ms. WAGNON. Thank you, Mr. Chairman, Congressman Delahunt, and Members of the Committee. I appreciate the opportunity to address you today. I am Joan Wagnon, Secretary of Revenue for the State of Kansas and Chair of the Multistate Tax Commission.

Today I represent the Commission and its members in our opposition to 1956, or BATSA, and I would like to make four points, which are elaborated in my written testimony.

First of all, BATSA's proponents claim it would ensure fairness and a level playing field, but that is wrong. It will lead to more nowhere income, corporate income that is beyond the jurisdiction of any State, and that is hardly fair to the rest of the businesses that pay taxes on all of their income and cannot take advantage of tax avoidance opportunities.

Secondly, BATSA will have a severe fiscal impact on many of the States. Many people on this Subcommittee have served in State legislatures. How would you have viewed a Federal law that would have forced you to raise taxes or cut services to replace lost corporate tax revenues, this Committee charged with making sure that administrative rules don't raise Federal taxes? Why would you allow that to happen to the State by passing this bill?

According to a study released just today by the National Governors' Association, H.R. 1956 could strip States of approximately $6.6 billion. That happens because it extends Public Law 86–272 to a variety of business taxes, not just corporate income, and shelter some income in safe harbors. NGA estimates that 11 percent of business activity tax could vanish as companies take opportunities to restructure and use the benefits of this bill. We figured in Kansas we would lose $25 million or more each year.

These tax breaks favoring certain kinds of large companies either force States to shift that tax burden back on property, sales or income taxes or reduce services like schools and health care. At a time when there is bipartisan support in Congress for shutting down tax shelters and closing loopholes in the Federal corporate income tax, it would be ironic if Congress enacted a bill to undermine the same critical source of revenue for the States.

Third, I want to give you some real examples developed by my Kansas staff of attorneys and auditors of how tax avoidance planning will work using the safe harbors in this bill to allow businesses that already have physical nexus in Kansas, and they will reduce their liabilities.

A manufacturing scenario, we have a tire company in Kansas that makes tires and sells them nationwide. Currently, all property income and sales are used to apportion income in Kansas. Using BATSA's safe harbors the company can reorganize itself into several entities, one to own the plant facility and equipment, an out-of-State company to own and lease the materials used for the tires, and a third to employ the Kansas factory workers. All remain com-

monly owned. Under the safe harbor for manufacturing materials, the out-of-State company suddenly has no nexus with Kansas and the value of the materials located at the Kansas plant would be excluded from the numerator of their property factor, and it reduces the Kansas apportionment factor and Kansas taxable business income. This would apply to our aircraft industry and many other manufacturing.

A retail scenario. Several out-of-State retailers of computers or electronic devices market their computers to their customers in Kansas via the catalog and Internet and use an independent contractor in Kansas to provide the warranty service to the customers. Under the independent contractor safe harbor, the out-of-State retailer now has no nexus in Kansas and we lose revenue which we currently have.

Financial services companies, banks, all are likely to restructure to benefit from H.R. 1956. Every service that a bank offers now can be conducted without a customer and a building. Out-of-State banks or Internet banks free themselves of their fair share of taxes while the smaller community banks see their customer bases diminish.

This threat to our tax base is real, not some manipulation of numbers for shop value in a public hearing. These are real examples, and they point out the unfairness of allowing preferential tax treatment for some businesses while others never gain this advantage.

Finally, for almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of States to raise revenues. Encroachment on State tax authority clearly violates the most principled value of Federalism on which our Nation was developed. The economy of the 21st century, as has been noted, is electronic and borderless. Most businesses can operate anywhere without physical presence. This bill takes 19th century tax law and imposes it on a 21st CENTURY economy and harms our States' abilities.

I ask you not to support it. Thank you.

[The prepared statement of Ms. Wagnon follows:]

PREPARED STATEMENT OF JOAN WAGNON

Mr. Chairman, Congressman Watt, and Members of the Subcommittee:

Thank you for the opportunity to address the Subcommittee concerning H.B. 1956, the Business Activity Tax Simplification Act of 2005. I am Joan Wagnon, Secretary of Revenue for the State of Kansas. I have previously served as President of Central National Bank of Topeka, Mayor of Topeka, Kansas, and as a six-term member of the Kansas House of Representatives.

Two months ago, I was elected Chair of the Multistate Tax Commission. The Multistate Tax Commission is an organization of state governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged by this law with:

- Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration;
- Avoiding duplicative taxation.

Created in 1967, forty-six states participate in the work of the Multistate Tax Commission. I am here today representing the Commission and its members in our opposition to HR 1956.

Overview

In reviewing the provisions of H.R. 1956, and its predecessors, I found plenty of provisions that troubled me, but I could not figure out what positive policy goals that the legislation would accomplish. So I turned to the website of the bill's proponents, *www.batsa.org,* and found that they claim it would accomplish four goals: ensure fairness, minimize litigation, grow the economy, and ensure a level playing field. In my review of the legislation and in consultation with many persons whose judgment I trust and value, I find that H.R. 1956 accomplishes none of these goals.

- Does it ensure fairness? No.
  - According to the Congressional Research Service, legislation such as H.R. 1956 would lead to more "nowhere income," that is corporate income that is beyond the tax jurisdiction of *any* state in our Nation. That's hardly fair to the rest of the businesses that pay taxes on all their income!
- Does it minimize litigation? No.
  - H.R. 1956 is anything *but* clear and simple. Any new set of rules is an invitation to litigate, but this change would invalidate forty years of judicial interpretation of P.L. 86–272 for no good reason.
- Will it grow the economy? No.
  - The economy suffers when businesses devote resources to reorganizing and restructuring to take advantage of tax laws instead of improving productivity. H.R. 1956 will also alter states' economic development strategies as more and more businesses seek to minimize physical presence in taxing jurisdictions. Furthermore, since the taxes affected by this legislation account for only about 1 percent of the output of non-farm businesses, it is difficult to see how enactment of this bill would unleash a great wave of business investment.
- Will it ensure a level playing field? No.
  - In my state of Kansas and in other states as well, smaller, more local firms will not have the opportunity to take advantage of the tax planning opportunities that larger, multistate firms would use under H.R. 1956.
  - For example, every service a bank offers can now be conducted without a customer in a bank building. Out of state banks or internet banks with their larger economies of scale can free themselves of their fair share of taxes while smaller community banks see their customer bases dwindle. Mortgage banking over the internet is just one good example.

It is clear enough that H.R. 1956 will not accomplish what it sets out to do. What is even worse is the severe impact that it will have upon the States. Many of you on this subcommittee have served in state legislatures. Think about that experience as I present three points for your consideration.

I. H.R. 1956 WILL FORCE OTHER STATE TAXES TO RISE TO REPLACE LOST STATE TAX REVENUES FROM H.R. 1956.

Section 4 of H.R. 1956 greatly expands Public Law 86–272 which covers only corporate income taxes, to add gross receipts taxes, business license taxes, business and occupation taxes, franchise taxes, single business taxes, capital stock taxes, as well as many others. In Kansas, H.R. 1956 will apply to our corporate income tax, corporate franchise tax, and bank privilege tax—a definite expansion of Public Law 86–272.

According to a study just released by the National Governors' Association, H.R. 1956 could strip states of $4.8 billion to $8.0 billion in much needed business activity tax revenues, depending on how widely it is used by businesses. Imagine what will happen to these states when an estimated $6.6 billion (the midpoint of the estimated range) in state revenues vanishes. This represents an estimated 11.4 percent of business activity tax collections by states as companies restructure to take advantage of the benefits authorized by H.R. 1956.

Kansas alone could easily lose $25 million, or more, each year under H.R. 1956, which is a large loss in our small state. We are coming out of the recession slowly, and are under court order to increase funding for schools dramatically. The state cannot afford any narrowing of our tax base. These tax breaks for a select group of large companies would simply shift that tax burden back onto property taxes, sales taxes or income taxes paid by individuals and small businesses in our states.

The only other option for states would be a dramatic curtailment of essential state services, such as schools, health and safety programs, etc.

II. H.R. 1956 IS INCONSISTENT WITH CURRENT FEDERAL POLICY BY PROMOTING TAX SHELTERING.

Congress and the Internal Revenue Service are currently challenging federal tax sheltering schemes. A report from Center for Budget and Policy Priorities said, "At a time when there is strong bipartisan support in Congress for shutting down tax shelters and closing loopholes that afflict the *federal* corporate income tax, it would be unfortunate and ironic if Congress enacted legislation like H.R. 1956 that would severely undermine the same—and equally critical—source of revenue for states." ("Federal 'Business Activity Tax Nexus' Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes," Revised May 9, 2005)

Professor John Swain writes in the William and Mary Law Review (Vol.45:319–20, October 2003) that "the physical presence nexus test motivates taxpayers to avoid physical presence in some jurisdictions while shifting property and payroll to tax havens." The Congressional Research Service reported that legislation such as H.R. 1956 would expand "the opportunities for tax planning and thus tax avoidance and possibly evasion." ("State Corporate Income Taxes: A Description and Analysis," CRS, Updated March 9, 2005).

"Tax sheltering," for state business activity tax purposes, means that income is not being fully reported to each state in a manner that "fairly represents" the business activity actually being conducted by the enterprise in each state in proportion to the property it uses, the people it employs or the sales it makes in each state. "Fairly represents" is a policy standard established in the Uniform Division of Income for Tax Purposes Act (UDITPA), as proposed by the American Bar Association.

HOW DOES H.R 1956 ENCOURAGE TAX AVOIDANCE?

Kansas uses a three factor formula of property, payroll and sales, and is a combined reporting state with a "throwback" rule. (States with a single factor formula, sales, will have much heavier losses.) If this law were to pass this year, the immediate impact on our state would be only $5–6 million, because companies would need to restructure to take full advantage of the tax avoidance opportunities which exist in the new law. But they will do this; why else would the proponents push so hard?

In 1989 Kansas had 33,581 corporate tax payers. Fifteen years later that number had dropped to 23,160 as taxpayers took advantage over time of changes in tax law, abandoned the C Corporation and started utilizing LLC's, LLP's, and a variety of other structures. Similarly, corporate income tax receipts now account for a much smaller portion (2.5%) of total state taxes collected by the department and deposited in the state general fund than they did even a decade ago (8.4%).

The point is that HR 1956 would stimulate another round of tax planning and tax avoidance, causing states' revenue streams to erode further.

The following 4 scenarios were developed by a team of Kansas auditors, attorneys and policy analysts who met recently to evaluate the fiscal impact of HR 1956. They looked at the manufacturing, retail and service sectors of the Kansas business tax base, analyzed the proposed legislation, and then figured out how certain businesses could lower their taxes using the "safe harbors" to allow businesses that already have physical nexus with Kansas to substantially reduce their tax liabilities.

Manufacturer scenario

Company A makes tires in Kansas and sells them nationwide. In order to take advantage of H.R. 1956 safe harbors, company A breaks itself up into several separate entities: company B owns/leases the plant facility and equipment in Kansas, company C, located out-of-state, owns/leases the materials used to make the tires, and company D employs the Kansas factory workers. All remain commonly owned. Under the safe harbor for manufacturing materials (up to the point those materials become the finished product/inventory), company C has no nexus with Kansas, and the value of the materials at the Kansas plant owned/leased by company C would appear to be excluded from the numerator of the property factor, thus reducing the Kansas apportionment factor, and Kansas' share of any taxable business income.

This same scenario could apply as well to an aircraft manufacturer in Kansas. An affiliated out-of-state entity owns/leases the materials (up to the point they become the finished product) being manufactured into aircraft. Another entity owns/leases the Kansas manufacturing facility, and yet another employs the Kansas factory workers. The owner of the materials and unfinished produced items would appear to be shielded from nexus under an H.R. 1956 safe harbor.

Retailer scenario

An out-of-state retailer of computers or other electronic devices markets its products to Kansas customers via the Internet. The sale of computers and electronic devices includes warranty contracts. The out-of-state retailer contracts with an independent contractor located in Kansas to provide the warranty service to its Kansas customers. The independent contractor provides similar services to other out-of-state retailers, all of which could be affiliates of one another. Under the independent contractor safe harbor in H.R. 1956, the out-of-state retailer now has no nexus with Kansas.

Financial Services Scenario

Kansas financial services company H breaks itself into companies I and J, which remain in Kansas, as well as broker K, which is located out-of-state. Broker K services the Kansas customers of companies I and J via Internet, mail or telephone. Income earned by broker K on sales of financial services to Kansas customers will no longer be taxable by Kansas.

Information/software Services Scenario

A Kansas company providing information and software support services to businesses in Kansas and other states breaks itself into in-state information services company X, in-state software support services company Y, and an out-of-state sales agency Z. Companies X and Y wholesale their services to agency Z, who in turn sells the services to businesses in Kansas, delivering the services via the Internet. Income earned by agency Z on sales of information and software services provided to Kansas customers will not be taxable in Kansas.

Kansas currently derives 67% of its corporate income tax revenues from the top 125 companies in tax liability. These companies have corporate income liability in excess of $300,000 each, and they are generally multi-state business entities. We can anticipate that some types of businesses will readily benefit more from the tax planning opportunities in H.R. 1956 than others. Brick and mortar retailers, large and small, will probably not be able to reduce their nexus exposure under H.R. 1956. Manufacturers may already utilize substantial tax incentives that reduce or eliminate their business tax liabilities. Without those incentive programs, however, manufacturers would be strongly motivated to restructure under H.R. 1956. Out-of-state Internet businesses, and service providers that can provide at least a portion of their services from remote locations (or restructure themselves to do so) will obviously be interested in taking advantage of H.R. 1956. These are not the only examples—but they reflect the tax system I know best, Kansas.

Our research says this threat to our states' tax bases is real—not some manipulation of numbers for shock value in a public hearing. The NGA report says the tax loss is too large to ignore. These examples, from real companies, point out the unfairness of allowing this kind of preferential tax treatment for some businesses to occur, while the vast majority of retail or small businesses in your states will never gain this advantage.

III. H.R. 1956 DOES GREAT DAMAGE TO OUR FEDERAL SYSTEM OF GOVERNMENT.

H.R. 1956 runs roughshod over federalism, placing Congress in the position of imposing a smorgasbord of federally-mandated state tax exemptions that would preempt hundreds of existing state and local laws and rules. For almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of states to raise revenues. H.R. 1956 would overturn the current constitutional "doing business" standard for state business activity taxes.

The "doing business" standard has been successfully defended in the courts of many states. In fact, the Supreme Court of the United States had denied *certiorari* in at least two instances where a state court has upheld the "doing business" standard. H.R. 1956 would have the effect of reversing these state court decisions. Such encroachment on state tax authority clearly violates the most basic principles of federalism upon which our Nation was built.

Conclusion

The economy of the 21st Century is electronic and borderless. Most businesses can operate anywhere and anytime without the encumbrance of physical presence. Technological developments have completely reshaped the manner in which business is conducted. Consequently, the business that utilizes modern technology to maximize a state's market may have no less of a presence in the state than the business that establishes a physical presence.

That is why the current standard of economic presence, taking into account property, sales and payroll, is fair. As Professor Swain points out, "equity is enhanced

by economic nexus because economic nexus ensures that similarly situated taxpayers are treated the same, both within each state and nationally."

H.R. 1956 takes 19th Century tax law and imposes it upon the 21st Century electronic, borderless economy. It replaces economic presence with "headquarters-only" taxation. It is a colonial concept of taxation wherein a company can receive the benefits a state offers without making a fair payment.

How does a multistate company with economic presence in a state receive benefits that state has to offer? It benefits from an enhanced market when a state's residents are educated by a state educational system paid for by state revenues. It benefits when it can adjudicate disputes in a state court system paid for by state revenues. It benefits when its trucks travel on that state's roads with that state's law enforcement officers keeping the road safe to transport that company's goods.

There is no compelling need for federal preemption of state and local law by switching from a system that works to a system that does not work. The Multistate Tax Commission, and its participating states, are always at work promoting fairness and uniformity. As a report from the Andrew Young School of Policy Studies at Georgia State University recently concluded, "To the credit of member states united by the Compact, the MTC has faithfully pushed the need for uniformity and cooperation against the competitive nature of states and the forceful challenge of corporate taxpayers." (Hildreth, Murray, and Sjoquist, "Cooperation or Competition: The Multistate Tax Commission and State Corporate Tax Uniformity," August, 2005).

Mr. Chairman, Congressman Watt, Members of the Subcommittee, thank you for the opportunity to present this testimony. Please do not support H.R. 1956.

Mr. CHABOT. Thank you very much.

Mr. Williams, you are our last witness here today.

TESTIMONY OF LYNDON D. WILLIAMS, TAX COUNSEL, CITIGROUP CORP.

Mr. WILLIAMS. Thank you, Mr. Chairman and Members of the Subcommittee. My name is Lyndon Williams. I am tax counsel for Citigroup. On behalf of Citigroup, I want to thank the Subcommittee for holding this hearing today on H.R. 1956, the "Business Activity Tax Simplification Act of 2005." I appreciate the opportunity to testify in support of this legislation.

Citigroup is one of the largest financial institutions in the world with 140,000 employees located in the United States and nearly 300,000 employees worldwide. Citigroup provides a diverse range of products and services to consumers, including banking services, credit cards, loans and insurance.

I am sure you are familiar with Citi Cards, for example. Citi Cards is one of the leading providers of credit cards in the United States with close to 80 million customers. Citigroup paid hundreds of millions of dollars in State business activity taxes annually in States where we have a physical presence and significant number of employees.

Unfortunately, a number of other States believe that the physical presence standard should not apply to them. They are seeking to enforce an economic nexus regime that forces a national bank to pay tax in States where, for example, its credit card customers reside. The fact that 100 percent of the bank's taxable income might be taxed in other jurisdictions where it is physically present would not matter. This is precisely the circumstance in which Citigroup's credit card bank finds itself.

Citigroup's major credit card issuer is established in South Dakota, where it employs over 3,000 South Dakota residents. It occupies buildings that exceed 425,000 square feet on 70 acres of land. Our employees benefit from the State school systems, the roads

and bridges, the fire and police services and other municipal services. The company attributes all of its taxable income to South Dakota, but some States believe that the same income should also be taxed again where the bank's credit card customers reside.

Our customers reside in every State. Under the commerce clause, Congress must ensure the free flow of goods and services among the States. A State tax against a corporation operating through interstate commerce requires substantial nexus.

The Supreme Court in *Quill v. North Dakota,* a case involving State sales and use tax collection responsibility, held a substantial nexus means that the out-of-State company must have physical presence in the taxing State. While many State courts agree with the *Quill*'s physical presence nexus standard—also applies to BAT, the business activity tax, some tax administrators and some State courts disagree. They argue that the *Quill* decision is limited to sales tax, meaning that a physical presence standard applies for sales tax and an economic presence standard would apply for income tax.

This construction of the commerce clause creates a hodgepodge of taxing standards leading to protracted litigation at significant cost to taxpayers and to State tax administrators. We believe H.R. 1956 goes a long way toward resolving these problems. The bill codifies the physical presence standard. A State or locality may not impose business activity taxes unless the business has a physical presence in that jurisdiction. H.R. 1956 would also modernize Public Law 86–272.

The law prohibits States from imposing an income tax on out-of-State sellers of tangible personal property if nexus arises solely from solicitation of customers' orders for goods that are approved and shipped from points outside the State. The U.S. economy has undergone significant changes in 46 years since this law was enacted. H.R. 1956 extends the long-standing protections of Public Law 86–272 to all sales and transactions, not just sales of tangible personal property.

In conclusion, H.R. 1956 would make clear, for example, that Citigroup's credit card bank is taxable in South Dakota and in all or all other States in which the bank has a physical presence. This is a far more appropriate, equitable and predictable standard for our business and for State revenue authorities than the tug of war that exists today.

We applaud Congressman Goodlatte and Boucher for their efforts and their perseverance in putting forward this legislation. We ask this Subcommittee to move this legislation forward as soon as possible so that the business community and tax administrators in the States have certainty and uniformity in the imposition and collection of business activity taxes.

Thank you.

[The prepared statement of Mr. Williams follows:]

PREPARED STATEMENT OF LYNDON WILLIAMS

My name is Lyndon Williams and I am a tax counsel in the tax department of Citigroup, specializing in corporate tax issues, including state taxation issues. On behalf of Citigroup, I want to thank Chairman Cannon, Congressman Watt, and the other members of this subcommittee for holding this hearing today on H.R. 1956, the "Business Activity Tax Simplification Act of 2005 (BATSA)." I very much appre-

ciate the opportunity to testify in support of this legislation and to discuss why the BATSA is so important to Citigroup and to the financial services industry in general.

Citigroup is one of the world's largest financial institutions, with 140,000 employees located in the United States and nearly 300,000 employees worldwide providing services to more than 200 million customers in all fifty states and in over 100 countries. While Citigroup engages in a variety of financial service businesses and offers many products and services to its customers, my primary focus today is Citigroup's consumer business. In the United States, Citigroup provides a diverse range of products and services to consumers, including banking services, credit cards, loans, and insurance. I'm sure you are familiar with Citi Cards, for example. Citi Cards is one of the leading providers of credit cards in the United States with close to 80 million customers and 119 million accounts. Consumers spend roughly $229 billion annually through our credit cards, which constitutes about 2 percent of the nation's Gross Domestic Product (GDP).

Citigroup subsidiaries operating throughout the United States pay hundreds of millions of dollars in state business activity taxes, in addition to state premiums taxes paid by its insurance businesses, payroll taxes, real and tangible personal property taxes, sales and use taxes on the purchase of goods and services and other miscellaneous taxes.

We believe we pay our fair share of state income taxes in those states where we have a significant number of employees and physical presence, and utilize the resources provided by the states in which we have these attributes. Unfortunately, as explained in more detail below, a number of other states believe that the physical presence standard should not apply. Instead, they prefer to impose business activity tax on companies solely because businesses provide products and services to customers in their states. This incongruity of taxing standards obviously causes a number of problems, including multiple taxation of the same income. Only Congress can act to provide a uniform standard that will clarify and simplify state business activity tax regimes for companies operating in interstate commerce.

BACKGROUND

The taxable income of a multi-state corporation is generally attributable to those states where the company has a physical presence, such as employees, an office, and other tangible property. Some states have asserted that, in addition, a multi-state corporation must pay taxes in those states where it does not have any physical presence because some of its customers might reside in their states. Economic presence generally refers to situations in which an out-of-state corporation does not own or lease real or tangible property, and does not have employees or facilities in the taxing state, but engages in solicitation of customers within that state creating some minimum connection between the state and the taxpayer.

For example, under an economic nexus regime, a national bank that issues credit cards to customers residing in states other than where the bank maintains offices, employees, or property would be forced to file tax returns and pay taxes in those states where it issues credit cards to customers, as well as where it has a physical presence. The fact that 100-percent of the bank's taxable income might have been subject to taxation in the jurisdictions where it is physically located would not matter because the bank would be required to pay tax again on the same income in the states where its customers reside or move to, even though the bank has no physical presence in those states.

This is precisely the circumstance in which Citigroup's credit card bank finds itself. Citigroup's major credit card issuer is incorporated in South Dakota. The company employs over 3,000 South Dakota residents, and is among the largest private employers in the state. It has resided in South Dakota for nearly 25 years. It occupies buildings, including offices and a daycare center, that exceed 425,000 square feet on 70 acres of land. Citigroup is the single largest taxpayer to the state of South Dakota, and the employees in South Dakota benefit from the school systems, the roads and bridges, the fire and police services, and other substantial services, infrastructure, benefits, and protections of the state. The company apportions 100-percent of its taxable income to South Dakota. In addition, some states assert that the same income is subject to tax in jurisdictions where the bank's credit card customers reside, and our credit card customers reside in every state in the nation.

H.R. 1956 would make it clear that Citigroup's credit card bank and similarly situated businesses are taxed where they have a physical presence. The substantial taxes paid by the bank to the jurisdictions where it is physically located is justified by the police and fire protection, the roads and bridges, the sewer and water systems, and other municipal services that the corporation and its employees enjoy. In

addition, the bill would provide predictability and certainty to the bank as to what its tax liabilities are and to which states those tax liabilities have been rightfully incurred.

SUBSTANTIAL NEXUS: PHYSICAL PRESENCE VS. ECONOMIC PRESENCE

Under the Commerce Clause of the constitution, Congress is vested with the responsibility to ensure the free flow of goods and services among the states. Thus, a state tax levied upon products and/or services conducted through interstate commerce meets constitutional muster only if an out-of-state corporation has "substantial nexus" with the taxing state. There has been much dispute and litigation over what is meant by "substantial nexus." The U.S. Supreme Court in *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), a case involving sales and use tax collection responsibility, held that "substantial nexus" means that the out-of-state company must have some physical presence in the taxing state for the tax collection responsibility to be constitutionally valid. Many state courts have concluded that the physical presence nexus standard of *Quill* also applies to business activity taxes, finding no support in the Commerce Clause for different nexus standards depending on the type of tax involved.

Yet, some state tax administrators and some state courts disagree. They have construed the *Quill* decision to mean, in essence, that the constitutional standard for taxing an out-of-state corporation depends on the type of tax being imposed. They argue that the *Quill* decision is limited to sales tax. Interpreted in this manner, the constitutional standard is physical presence (i.e. in-state employees, an office, property) if a sales tax is involved, and economic nexus (i.e. merely having in-sate customers) if an income tax is involved.

This construction of the Commerce Clause produces different results not only depending on the type of tax involved but also the type of industry involved. This is because Public Law 86–272 prohibits states from imposing an income tax on the out-of-state seller of tangible property if nexus arises solely from the solicitation of customers' orders for goods that are approved and shipped from points outside the state. Therefore, as a practical matter, the physical presence standard would control in the case of manufacturing.

On the other hand, service and other significant non-manufacturing industries are not explicitly protected by Public Law 86–272, creating a disparity among industries operating in interstate commerce.

This disparity in the taxation of activities conducted in interstate commerce may lead to protracted litigation at significant costs to taxpayers and state tax administrators. It has also lead to great uncertainty and unpredictability in the manner in which multi-state businesses are taxed and inconsistency with international standards applicable to many of these multi-national businesses.

THE PROVISIONS OF H.R. 1956

We believe H.R. 1956 goes a long way towards solving these problems, which are becoming increasing vexing for companies and taxing authorities alike.

Physical Presence Standard. H.R. 1956 codifies the physical presence standard by providing that a state or locality may not impose business activity taxes unless businesses have "physical presence" in the jurisdiction. The required physical presence is a bright line test that establishes tax jurisdiction where an out-of-state business has employees, property, or the use of third parties to perform certain activities within a taxing state for greater than 21 days during a taxable year.

For instance, H.R. 1956 would permit a business to send employees into a state for 21-days in any year and not give rise to an obligation for that state's income tax. H.R. 1956 thus would let employees perform transitory assignments and not trigger unintended tax obligations. Guidance on what activities a firm can conduct within a state that will not trigger that state's taxing power will provide certainty to businesses and tax administrators and will reduce compliance and enforcement costs.

H.R. 1956 attributes the physical presence of a person in the state to an out-of-state business if that out-of-state business uses the services of the in-state person for more than 21 days to establish or maintain market in the state, unless the in-state service provider performs functions for more than one business entity during the year. The ownership relationship between the out-of-state person and the in-state person is irrelevant for purposes of this provision. The legislation recognizes that to the extent that a separate company is independently conducting business in a state for which it is compensated by an out-of-state entity, the economic income earned in the state will be subject to tax.

Modernization of Public Law 86–272. The U.S. economy has undergone significant changes in the 46 years since Public Law 86–272 was enacted. Many of the companies, products, and services that make the U.S. economy so vibrant today were not even imagined when this law was enacted. Thus, H.R. 1956 extends the long-standing protections of Public Law 86–272 to all sales or transactions, not just to sales of tangible personal property.

H.R. 1956 also modernizes Public Law 86–272 by addressing the efforts of some states to avoid the restrictions imposed by Congress in Public Law 86–272. Specifically, some states have established taxes on business activity that are measured by means other than the net income of the business. Two examples of these new state business activity taxes are the Michigan Single Business Tax, which imposes a tax on a company's business activities in the state, not on net income, and the New Jersey Corporation Business Tax, which was amended in 2002 to impose a gross profits/gross receipts tax. In other words, New Jersey has effectively circumvented the Congressional policy underlying the enactment of Public Law 86–272 by imposing a non-income tax on businesses that could otherwise be protected by the Public Law. While other states may not enact such a targeted end-run around Public Law 86–272, it is likely that states will increasingly turn to non-income based business activity taxes. H.R. 1956 addresses this by ensuring that Public Law 86–272 covers all business activity taxes, not just net income taxes.

RELATIONSHIP TO INTERNATIONAL TAXATION

The United States and its tax treaty partners have, for decades, adopted and implemented the physical presence standard for determining the tax jurisdiction of multinational corporations. This standard is embodied in the "permanent establishment" concept, which is a long-standing principle of the U.S. tax treaty regime, and is part of the OECD model treaty.

The "permanent establishment" rule provides that neither country that is a party to a bi-lateral tax treaty will impose an income tax on a business from the other country unless that business maintains a substantial physical presence in the taxing country. Using the U.S. Model Treaty provisions as an example, a foreign business must have a "fixed place of business [in the United States] through which the business of an enterprise is wholly or partly carried on" before the United States may impose a tax on that business. A fixed place of business includes a place of management, a branch, an office, a factory, a workshop, etc. In addition, a deemed permanent establishment may arise if an in-state agent (other than an agent of an independent status) is acting on behalf of an out of-state enterprise where the in-state agent habitually exercises authority to conclude contracts that are binding on the out-of-state enterprise. The activities of an in-state independent agent acting in the ordinary course of its own business are not deemed a permanent establishment of the out-of-state enterprise.

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. It is significant that the OECD has recently studied the issue and concluded that the "permanent establishment" rule should remain the proper standard for international tax treaties even with the proliferation of electronic commerce. The policy reasons underlying such a conclusion are clear in maintaining the free flow of commerce among trading partners.

CONCLUSION

Congress has a responsibility under the Commerce Clause to provide a uniform standard under which multi-state companies are taxed by different states. H.R. 1956 would codify the physical presence nexus standard. The bill would make it clear, for example, that Citigroup's credit card bank is taxable in South Dakota and in any other state in which the bank establishes a physical presence. This is a far more appropriate, equitable, and predictable standard for our business and for state revenue authorities than the tug of war that exists today.

H.R. 1956 describes minimum levels of activity that a business could conduct in a state and not trigger liability for tax in that state. Clear guidance on what activities a company can conduct within a state that will not trigger that state's taxing power will provide certainty to businesses and tax administrators and will reduce compliance and enforcement costs. BATSA also would bring Public Law 86–272 up to date to reflect an economy that has changed dramatically since 1959, thus treating products and services offered by all businesses in a fair and equitable manner.

Versions of H.R. 1956 have been introduced in the last several Congresses, and we applaud Congressmen Bob Goodlatte and Rick Boucher for their perseverance in this effort. In the meantime, a number of states have taken aggressive action to

tax companies like Citigroup based on the economic activities of its customers rather than the physical presence of its employees and its businesses, creating a hodgepodge of taxing standards and an increased tax and compliance burden for companies that serve customers nationwide. We ask this subcommittee to move this legislation forward as soon as possible so that we in the business community and tax administrators in the states have certainty and uniformity in the imposition and collection of state business activity taxes.

Mr. CHABOT. Thank you very much, Mr. Williams.

I would like to commend all four witnesses, actually, for coming in right on time at the 5 minutes. It is quite impressive. It takes hard work to get it down to 5 minutes. Some people ignore it. So I really want to commend you for doing that and for the excellent testimony you gave.

Members of this panel will now have 5 minutes to ask questions, and I recognize myself for 5 minutes for this purpose. Let me start with you if I can, Mr. Horne. Is the current State taxation and taxing situation such that many small businesses fear for the viability of their businesses.

Mr. HORNE. I think the main problem today is that small businesses are unaware of the environment in which they operate. We are naive. We had no idea of this problem until we were trapped by New Jersey. But it is a very, very frightening environment once you are trapped. And I had one young woman victim from another State, actually, Mr. Goodlatte's State. She tracked me down and called me. She was in tears, so desperate for help, to try to learn how to deal with this nightmare. So, I mean, I don't know what else to say.

Mr. CHABOT. Thank you. Let me turn to you, Representative Ehrhart, now. In your opinion, what do you think would happen if Congress does not act and does not enact H.R. 1956 or similar legislation? Do you foresee a problem with States asserting greater taxation authority over companies with even less of a connection in a State than those that are taxed now?

Mr. EHRHART. I think with a new economy certainly you will. Those who have the proclivity to seek out anything that moves, taxing whatever they may be able to get their hands on, or they will be taxing our memory very soon—not to be flippant, Mr. Chairman—but I think you are going to find just across the board, if Congress doesn't act, you are going to find States getting more and more aggressive. You are going to have local municipalities and maybe county governments, who take this as almost carte blanche to begin to tax, based on whatever type of direct tax they can apply to an out-of-State, out-of-area business.

With the new economy, we are just going to bring the bad old tax laws into the new economy. I just think that is bad policy. We in Georgia have tried to stay away from that. We stay with the basic nexus under Public Law 86–272.

Mr. CHABOT. Thank you very much. Secretary Wagnon, let me ask you, if I can now, what is your response to stories from companies such as ProHelp Systems here, in

Mr. Horne's case, or Smithfield Foods, whose deliveries are being stopped at the roadside and whose businesses are being severely disrupted by States demanding payment for BATs? Shouldn't there be a reasonable standard for such companies?

Ms. WAGNON. I guess my response is threefold—and I don't wish to be flippant, but I would like Mr. Horne to come to Kansas. We don't treat our small business people like that. He can certainly sell his goods and services there. We have an exclusion, a de minimis standard in our franchise tax, so he would fall under that de minimis standard and wouldn't even be taxed.

I guess in a broader sense I spend a lot of time in the Kansas legislature working with NFIB, and I have not heard a single story similar to the one that I have heard from him in any other complaints. They are far more concerned about property taxes and some other things like that.

I guess finally, I would say, I think small business is really going to be the loser in all of this, if we allow the very large multistate corporations to develop a lot of nowhere income or to shift their income in such ways that States are faced with this huge loss. You look at what NGA has proposed in their study and at $6.6 billion of State tax revenues that will be lost.

Well, you all know that we are not going to cut $6.6 billion worth of services, and so that burden is going to fall back onto the taxpayers that probably have fewer tax planning resources, sub-S corporations, individual income tax, property tax, sales tax. So I think it is a very bad move to push that burden back onto the very people that he is trying to help.

Mr. CHABOT. Thank you. Mr. Williams, how would H.R. 1956, the bill that we are considering here, the Goodlatte bill, create tax certainty for businesses?

Mr. WILLIAMS. Well, it creates tax certainty because it establishes one standard, one standard for businesses, whether small or large businesses, that operate in interstate commerce, and that standard would be physical presence. It would be a clear standard, and it would be a standard that is predictable and certainty would be clear from that standard.

Mr. CHABOT. Thank you very much. I have only got 8 seconds left. So rather than ask another question, I will give back my time, and I will yield to the gentleman from Massachusetts, Mr. Delahunt, for 5 minutes.

Mr. DELAHUNT. Yes. Thank you, Mr. Chairman. This is a thorny issue, as I said in the opening statement, I think there are arguments to be made on each side. I think that the example put forth by Mr. Horne is—I thought you responded well to that. I would suggest that possibly this Congress could consider a small business exemption to deal with the problem presented by Mr. Horne, so that small businesses would be protected.

At the same time, I have huge concerns about the revenue that is necessary for the local and State governments. Now, I am sure that there are some that don't believe that local and State governments should even impose taxes, but I think we have seen, particularly recently in the aftermath of the natural disasters that occurred in the Gulf States, that it doesn't work, it is unrealistic.

And yet at the same time I think there's a consensus that we are in a new economy, and we have to be creative, and we should do some thinking out of the box, so to speak. But what I find frustrating is that doesn't appear to be happening. What we are hearing now are the same arguments presented. Can anyone tell me

whether there is any discussion going on about presenting a consensus to the Congress in terms of creating an articulable standard, other than physical presence, that would be satisfactory to the business community and at the same time satisfactory to the local and State jurisdictions that so badly need some revenue?

Ms. WAGNON. I would be happy to take a shot at answering your question, sir, if that would be appropriate.

Mr. DELAHUNT. Is there somewhere, some file that I can have some confidence in?

Ms. WAGNON. A little bit. For the last 5 years the States have gotten together in a remarkable effort to try to organize the streamline sales tax.

Mr. DELAHUNT. I am very familiar with it.

Ms. WAGNON. I have been right in the middle of that, as many of us have. It has taken a huge amount of energy. But that kind of organization, where States come together, design a solution, in concert with business, is the appropriate way for that to happen. The Multistate Tax Commission, which has also been a partner in the streamline sales tax, has been working on a factor presence, nexus standard, for economic nexus, that would take into account the realities. It also has that $500,000 de minimis standard that you referred to, which totally solves Mr. Horne's problems.

I think if we leave this hearing and determine that streamline is now up and running, and this may be the next area where we turn our attention, that may be a good idea.

Mr. DELAHUNT. I would really encourage that. Representative.

Mr. EHRHART. Congressman Delahunt, one of the pieces being left out of that particular equation, and you certainly have taken into consideration in your remarks, is what do the people of this country think and what do they want for their new economy, because they are the participatory part of that. And every sampling of public opinion, especially with respect to SSTP, has been that they don't want to move toward taxing that the way it was—the way other goods and services have been taxed. The people do feel like the tax bill burden on themselves and even on their businesses obviously is too large. We should move towards—and I think 1956 does that with their de minimis standards. It really doesn't get outside the nexus that we have.

Mr. DELAHUNT. I hear what you're saying, but let me just read the conclusion of the Congressional Research Service, which is a branch of the Library of Congress, in its analysis of H.R. 1956. "The new regulations as proposed in H.R. 1956 would have exacerbated underlying inefficiencies because the threshold for businesses, the 21-day rule, higher than currently exists in most States, would increase opportunities for tax planning leading to more income. In addition, expanding the number of transactions that are covered by P.L. 86–272 also expands the opportunity for tax planning, and thus tax avoidance and possibly evasion."

I know there's no easy answer here, but this is a nonpartisan, independent agency.

I see the red light is on.

Mr. CHABOT. The gentleman's time has expired. If you'd like to respond briefly.

Mr. EHRHART. Just very quickly. I also read that particular report, and the part that was relevant to me was that it says, as a result, BATs actually provides States with more opportunity to tax interstate commerce than would be available under the ALEC majority report recommendation. So it seems to take both sides of the issue even there, which is generally the case in many of these things.

Mr. CHABOT. The gentleman's time has expired.

The gentleman from North Carolina Mr. Coble is recognized.

Mr. COBLE. Thank you, Mr. Chairman.

Mr. Chairman, as you accurately pointed out, we have a distinguished panel, and I thank you all for being here, as the Chairman indicated.

Ms. Wagnon, when I indicated at the outset that tax collectors grab every thin dime that's not nailed down, I didn't mean that against you personally. I was acknowledging the fact that county and tax collectors have a job to do, and they should lawfully grab every thin dime that's not nailed down. But I am confident, folks, that there are some taxing authorities or jurisdictions that have unfairly and/or overly aggressively sought payment of business activity taxes without basis. Do you all agree with that generally.

Mr. HORNE. I certainly do.

Mr. COBLE. Having said that, if we don't pass or enact 1956, Secretary Wagnon, how would you address that problem of overaggressiveness or unfair solicitation?

Ms. WAGNON. Well, I didn't respond to your question about did I agree with you because I'm not so knowledgeable about every State. I'm not aware that States are exceeding laws that are legitimately passed by their own State legislatures. I think tax departments do collect that which is due and owing because that's their job, but they collect them under laws that the legislature has allowed them to do. And so the question then becomes are some States' laws more aggressive than others. What the Multistate Tax Commission is trying to do is to get to that standard of uniform laws that we can recommend for all States that balances that fairness.

Mr. COBLE. My time is running. I drew my conclusion based upon the testimony that we heard here this afternoon regarding the overaggressiveness.

Let me talk to my friend from Georgia.

Ms. WAGNON. Certainly.

Mr. COBLE. I assume, Mr. Ehrhart, that you would agree that—well, strike that. I shouldn't insert words into your mouth. Do you agree that in some cases challenging assessments through State courts is unfair to out-of-State businesses?

Mr. EHRHART. Certainly it is, because especially under the commerce clause, and then you go back to *Quill*, our previous precedent, you have the situation where business is at least entitled to the same treatment in every court in every State. You can't set up a different standard in each State. That would be completely unjust.

Mr. COBLE. I'm inclined to agree with that, too. But let me ask you this, Mr. Ehrhart, any of you, would you all support making Federal courts available to hear State assessment cases? That may

be a slippery slope that we may be approaching. I'm not suggesting that I endorse that, but I'd be glad to hear what you all think to that.

Ms. WAGNON. No.

Mr. COBLE. Mr. Williams.

I didn't mean to cut you off, Mr. Ehrhart.

Mr. EHRHART. I was going to state I thought *Quill* was very eloquent with respect to the physical presence standard. I think that's applicable here and in SSTP.

Mr. COBLE. Mr. Williams.

Mr. WILLIAMS. This is an issue involving in the Constitution, and clearly the availability of the judiciary is very important at all levels, and if Federal courts were available, I believe that that would be another avenue for businesses to have redress to these issues that are very important to the U.S. Economy as well as to businesses navigating in interstate commerce.

Mr. COBLE. Mr. Horne.

Mr. HORNE. I would certainly like to be able to deal with New Jersey with a South Carolina lawyer in South Carolina in Federal court as opposed to a New Jersey lawyer in a New Jersey court.

Mr. COBLE. Ms. Secretary, you want to be heard as well?

Ms. WAGNON. If I might expand upon my answer. These cases and the misunderstanding that exists about what *Quill* did or did not say about substantial nexus are making their way through the court systems right now. The Lanco case is on appeal; the ANF case is being appealed to the United States Supreme Court. To bypass a State court on a issue of State law, I believe, is a constitutional problem.

Mr. COBLE. Mr. Chairman, knowing of your affinity for beating the red light, I yield back my time.

Mr. CHABOT. I appreciate the gentleman yielding back.

The gentleman from Arizona Mr. Franks is recognized for 5 minutes.

Mr. FRANKS. Thank you, Mr. Chairman.

I understand I have a little different type of microphone up here. So everyone can hear me?

I know, Mr. Horne, that a lot of times these kinds of concerns from Congress come only after a great deal has already happened at the State level, but there's been just a trend in the testimony with most of the members of the panel today that it seems that the States are becoming more aggressive in asserting the authority to impose business activity taxes. Do you agree with that statement? Is it a recent phenomenon; is it something you see as an escalating issue?

Mr. HORNE. I think it's a growing phenomenon, and I've got some examples if you'd like me to cite them for you.

Mr. FRANKS. Do you think it's something becoming pervasive, and they see this as a new idea, and they think this is a way to——

Mr. HORNE. Absolutely, absolutely.

Mr. FRANKS. Mr. Ehrhart, probably the most compelling part of Ms. Wagnon's testimony to me was the assertion that there was a 10th amendment or States rights issue here, or constitutional

issue. Can you tell me if you think that 1956 infringes on State sovereignty?

Mr. EHRHART. I think it's exactly the opposite. I think it protects the federalist principles, and ALEC, being a federalist-based organization, it stands the world on the head. Obviously there's always been a tension between the commerce clause and the basic 10th amendment provisions, but the practical realities of that have withstood the test of time with precedent after precedent being set in statute and in Supreme Court precedent with respect to—you can't have an impractical—every State taxation that's different for every company. I mean, it would become an amazing hodgepodge of every jurisdiction. You could not spend enough money as a small business to begin to understand the tax policy in all 50 States and every county in every State, and that's the practical reality. How are you going to get to that point? It's like the only intangible tax we used to have in Georgia, took 8 years to get rid of it. It's one of those taxes that costs more to administer than it brought in.

This is the same kind of thing. It's going to take States huge amounts of legal time and effort to track this down. It's going to be more expensive to administer than it is to—actually how much money they bring in. So I don't think there's any tension at all; I think this is the federalist position, one we take.

Mr. FRANKS. Ms. Wagnon, I have to be fair and give you a chance at that. Let me ask you if I could ask you to also include in your answer, Mr. Ehrhart testified that 1956 will foster economic growth and job creation in the States because businesses will have a little better idea of what their capital risks are or their capital associated with taxation is. And I know that in Arizona that is true. We have taken into consideration every way that we can the impact of our tax code upon businesses coming into Arizona in just about any form. It has resulted in a broadening of the tax base and an increase in the revenues. And so I guess I throw a couple of those things related to the sovereignty and economic growth that this may create in the States.

Ms. WAGNON. I'm joined in my opinion that this is a threat to State sovereignty by the National Governors Association and the National Conference of State Legislatures, Federation of Tax Administrators, and the Multistate Tax Commission. So I'm not alone in that opinion. And we do believe that Congress has done a good job of staying out of the States' business while protecting interstate commerce.

With respect to economic development, we sit in our legislature, and I know other States as well sit in their legislatures, every day in session and try to figure out ways to remain competitive as we compete with each other for the best companies and for the best way to do business. States are far more in danger these days of giving away too much of their tax base in order to be competitive than to be out being a threat to business, looking for ways just to raise their taxes. And so I think we need to be careful in this debate not to characterize States as the villain or business as the villain. I think we need to just recognize that the changing in economy is looking for balance, and this bill does not provide that balance.

Mr. FRANKS. Mr. Williams, I think I may have one more question here in my time. The physical presence nexus, do you believe that

that is the appropriate standard for business activity taxes, and tell me why, what is your rationale for that, and just give us a little insight on what other possible criteria there might be.

Mr. WILLIAMS. Thank you, Congressman.

Yes, I do, I believe the physical presence standard is the proper standard that should apply. Most of the arguments that have been made, including the revenue projections that have been made, labor under an assumption of what's called tax sheltering, which we've heard here. But States do have tools, they do have an arsenal of tools that's within State laws and that can be created within State laws to address those issues. And we haven't heard an argument as to why those State laws are not sufficient to address the concerns that have been raised in opposition to this bill, but I must say that the issue of whether or not a business is able to conduct activities in interstate commerce is a unique issue that Congress must focus upon, because States do have individual competing interests in terms of their own budget and revenue concerns. And we believe that the physical presence standard provides certainty, predictability, and allows all business to pay taxes where they are located and where they receive benefits and protection.

Mr. FRANKS. Well said.

I yield back.

Mr. CHABOT. Thank you. The gentleman's time has expired.

The gentleman from Maryland Mr. Van Hollen is recognized for 5 minutes.

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I thank the witnesses. I apologize for being late. I didn't have an opportunity to hear your testimony. I've been trying to look through it and listen carefully to the questions.

Just with respect to whether or not States are being more aggressive in terms of trying to collect these taxes, I think it's important that we probably try and get CRS or somebody to take a look at that. As I understand what CRS has written, at least in the materials we've got, is that State tax collections from corporate incomes taxes have decreased recently. Now, that can be a combination of factors, people can lower tax rates, but it doesn't appear anyway that they're making up in a big way by being overly aggressive, at least on a uniform basis. Obviously you can look at individual States.

Let me just make sure, I want to understand Representative Ehrhart. Now you're here testifying on behalf of yourself as a representative of the Georgia State Legislature.

Mr. EHRHART. On behalf of 2,400 members of the ALEC organization, a bipartisan group of legislators, as chairman of the organization, and as I myself.

Mr. VAN HOLLEN. Has the Georgia State Legislature, the house or State senate taken a position on this legislation?

Mr. EHRHART. Not specifically to the legislation, but what we do is we stick with Public Law 86–272. I spoke with our revenue commissioner and his staff before I came up here, and we create the nexus and standards, and it's basically physical presence that was done under the congressional act in 1959.

Mr. VAN HOLLEN. Has the State of Georgia, the legislature in Georgia as it's represented through NCSL, has the State legislature voiced an opinion?

Mr. EHRHART. Not on the NCSL provisions. Most of the members in Georgia belong to both organizations, as a matter of fact.

Mr. VAN HOLLEN. But NCSL, you're aware, is opposed to this legislation.

Mr. EHRHART. We tend to generally take different positions on tax policy.

Mr. VAN HOLLEN. As well with the National Governors Association?

Mr. EHRHART. We're generally more in line with them. In this instance they are.

Mr. VAN HOLLEN. In this case you're on the opposite side.

I guess we've talked about the 10th amendment issue, and obviously there are differences of opinion, but it seems to me that those two organizations, NGA and NCSL, are certainly as protective of States rights, especially when it comes to these areas, as other organizations. You don't think that they're a good custodian of State rights?

Mr. EHRHART. No, I would not, not on 10th amendment issues, no, sir.

Mr. VAN HOLLEN. Is it your testimony that—let me ask you this: Taking the State of Georgia, is this going to lead to a net increase or decrease, or will it be neutral because of the way you currently collect?

Mr. EHRHART. I would expect it would be a net increase for the State of Georgia if 1956 passes because of the economic development side. Businesses will have some certainty, and that is that type of economic theory that if you make it attractive for business to do business, they will create more revenue and more productive capacity.

Mr. VAN HOLLEN. Are their any analyses that have been done in the State of Georgia as to whether this would be a net gain or loss for the State of Georgia?

Mr. EHRHART. Not at this time.

Mr. VAN HOLLEN. So you're speculating then based on the perceived business development. I just want to understand what the basis of the answer is.

Mr. EHRHART. Based on the philosophical premise of the ALEC organization.

Mr. VAN HOLLEN. Let me ask you, Ms. Wagnon, what was the number you gave for what—your projected net loss?

Ms. WAGNON. In Kansas, 25 million.

Mr. VAN HOLLEN. Do you have a figure, an estimate from NCSL or elsewhere, as to what the aggregate loss in State revenue would be?

Ms. WAGNON. For all the States, $6.6 billion.

Mr. VAN HOLLEN. $6.6 billion.

I understand, Mr. Ehrhart, you believe it's just the opposite; that because of the economic development potential, you're actually going to gain revenues.

Mr. EHRHART. There are two sides. They're still at war.

Mr. VAN HOLLEN. Let me just say in closing, this obviously, as has been said, it's an issue where I think that we should be able to come up with a reasonable approach and a bipartisan approach on this issue. Obviously you want some predictability if you're a business as to whether or not if you engage in certain kinds of economic transactions with the State, whether you're going to be subject to their corporate income tax. On the other hand, clearly it seems to me there are some, clearly many, cases where people are clearly engaged in enterprises and business within a State even though they're not physically present in a State, and seems to me that too narrow a test doesn't allow that State to recoup what I think would be its share of various costs from businesses doing transactions in the State. So I just associate my remarks with Congressman Delahunt and some of the points he made. I think that there is room, and the Chairman and others, that we can work something out. Thank you very much.

Mr. CHABOT. Thank you. The gentleman's time is expired.

We're going to go to a second round, but the Members have agreed we're going to reduce our 5 minutes down to 3 just for a little wrap-up here, and I'll yield myself 3 minutes at this time.

Mr. Horne, let me go to you first, if I can. Getting back to your specific case, could you tell us again what was the tax that was being imposed upon you; and secondly, what are the expenses that you have incurred thus far as a result of New Jersey's attempt to get this tax from you?

Mr. HORNE. If I understand your question correctly, the tax New Jersey was applying to us was a business activity tax in the form of a minimum tax. New Jersey has a minimum tax of $500. In our case, if you use the calculated tax with New Jersey rates, in our best year, if I recall correctly, our tax was, I think, $0.83. That quickly escalates to $500, plus the requirement to register our company in the State; therefore, it's basically $600 per year in order to sell anything in that State. That's the way their income tax form reads.

Mr. CHABOT. How much have you spent thus far as a result of, approximately, trying to battle this thing?

Mr. HORNE. In terms of legal fees, I think we're somewhere in the area of $3-, $4-, $5,000. I don't recall the exact number. We've tried to keep the fees down as much as we can. Our attorney did give us a favorable rate. But far more important than the legal fees was the impact on our business. It took us, my wife and myself, approximately 100 hours of our time to come up with the fact that we'd only sold seven licenses in the State of New Jersey. As a small business we do not keep records by State. We had no choice other than to go through individual pieces of paper for the last 7 years in order to identify the fact that we'd only sold seven licenses, consisting of a total—with associated services, I think the number was $6,133 over a 6-year period, and 3 of those years the numbers were zero. In one it was $49. It took us about 100 hours of time to come up with those numbers.

Mr. CHABOT. Thank you.

Rather than ask another question, my time is ready to expire, so I'll yield back.

The gentleman from Massachusetts is recognized for 3 minutes.

Mr. DELAHUNT. I want to just make a comment. I agree with you, Madam Secretary, and I disagree with you, Representative. I think the States can really sit down and hammer out a simplified, coherent system that addresses this problem. I think they've already done that dealing with the SSTP. And I would encourage you to do it.

I said this at the last hearing: This is going nowhere, okay? Some might believe that it's going somewhere, but it will not pass, and I think it's important that we all work together to make it happen.

The case presented by Mr. Horne, I think, is an egregious example. We support you, Mr. Horne, and it's got to be addressed. At the same time, economic activity should be implicated into a fair and equitable formula.

Mr. Williams, which of those States that you alluded to that don't embrace the physical nexus standard—give me two or three quickly.

Mr. WILLIAMS. Sure. Tennessee, Massachusetts, and Indiana.

Mr. DELAHUNT. Let's take Massachusetts, for example. What is the revenue that is generated by Citibank in South Dakota?

Mr. WILLIAMS. Well——

Mr. DELAHUNT. If you know.

Mr. WILLIAMS. I don't know what the actual revenues that are generated by Citibank in South Dakota.

Mr. DELAHUNT. Do you know what they are in Massachusetts?

Mr. WILLIAMS. I don't have the actual numbers with me.

Mr. DELAHUNT. Would you agree with me that the business activity, economic activity, the profits to the bottom line generated in Massachusetts are substantially greater than those generated in South Dakota?

Mr. WILLIAMS. I'm not an economist, but I could not——

Mr. DELAHUNT. How many people live in South Dakota? Do you know?

Mr. WILLIAMS. I understand your question, but I want to make sure you understand this also, that——

Mr. DELAHUNT. I want you to answer my question. That's the game that we play here.

Mr. WILLIAMS. Sure.

Mr. DELAHUNT. You can answer my question.

Mr. WILLIAMS. I don't know how many people live in Massachusetts, nor do I know——

Mr. DELAHUNT. Six million. I know that there aren't 6 million people in South Dakota. I daresay that there is significantly more economic activity and profit resulting from—resulting to Citigroup as a result of economic activity in Massachusetts.

What I'm suggesting to you—and I understand you represent a corporation, and your responsibility is to make as much profit as possible. And that's good; that's our system. But those of us that are here as policymakers and you're asking us to do something have a much more expansive, broad responsibility in terms of public policy. Taxation is about public policy, and what we want to do is work on—work together to see whether we can achieve a fair and equitable solution so that no State is disadvantaged and that no business is disadvantaged.

Mr. CHABOT. The gentleman's time has expired.

The gentleman from Arizona is recognized for 3 minutes.

Mr. FRANKS. Mr. Chairman, thank you.

It occurs to me that we wouldn't be having this debate if it weren't for the fact that this is interstate commerce. I mean, there has to be, and that should be considered very strongly on any sovereignty argument, and it also occurs to me that the States will be the first ones to be grateful for the clarity that this represents, because I think it will end up being something that will foster the economic growth in those States and ultimately affect their bottom line revenue in a favorable way. That's a perspective that I have on that.

But, given that, Mr. Williams, why should the Public Law 86–272 be modernized. There's a reason; you understand I'm asking you this for a reason. It seems that New Jersey especially has kind of undermined the will of Congress in that legislation, pretty clearly, and how would 1956 solve this circumventing of that public law? Can you give us a little insight on that?

Mr. WILLIAMS. Well, the way that New Jersey actually changed their law—the 86–272 was intended to address business activity taxes. The statute, I believe, says net income taxes. So what has happened is that States like New Jersey have changed the tax to something that is not called a net income tax, another base, and on that basis assert that Public Law 86–272 would not apply just by changing the type of tax that's being assessed.

We believe that the modernization of Public Law 86–272 would, first of all, address that issue. It would make sure that all taxes related to business activity regardless of how they are called would be within the scope of Public Law 86–272. In addition to that, we would not have conflicting standards for one type of industry versus another, where for manufacturers you have one type of—you have Public Law 86–272; a nonmanufacturing industry, which is a significant portion of the U.S. Economy, are not protected by this statute. We believe the modernization would allow for a level playing field and would allow businesses to conduct interstate commerce in a smooth and efficient way.

Mr. FRANKS. Thank you, Mr. Williams.

Mr. Chairman, I guess I would just suggest here in closing that our economy doesn't work just on competition, it works on a framework of trust and a framework of predictability among business leaders and those that are involved in business. And for us to be able to present that clear framework for them is, in my judgment, going to be a positive thing for the economy across the board and certainly will ultimately, as I say, favor the States in their revenue collection because it would broaden the base we collect. Sometimes we forget it's all about productivity, and we get so caught up in some of the nomenclature, that productivity is the bottom line, and I think this is the primary reason for such a bill.

Mr. CHABOT. The gentleman's time has expired.

Before we recognize the gentleman from Maryland, I'd ask unanimous consent to enter into the record some documents submitted by the gentleman from Massachusetts and the accompanying documents. Without objection, so ordered.

[The information referred to can be found in the Appendix.]

Mr. CHABOT. The gentleman from Maryland Mr. Van Hollen is recognized for 3 minutes.

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I'm not going to take up all of that time, but since I last asked the question, Mr. Ehrhart, I came across some documentation that says that the Georgia Department of Revenue recently reported the passage of this bill would reduce State revenue by $30.9 million. Are you familiar with that State Department of Georgia Revenue estimate?

Mr. EHRHART. I'm not familiar with that, no, sir.

Mr. VAN HOLLEN. I think as we discuss this and the impact of this legislation, it's important to have facts and analyses and the basis for analyses and the basis for economic projections. We've got a swing here from a $6 billion loss to the States, and apparently, according to the Georgia Department of Revenue, including a $30.9 million loss to the Georgia, to a projection really, as far as I understand, based on an assumption that it's going to be a net revenue producer.

What would be very helpful if we really are going to go down this road is to get the economic analyses that shows exactly how, if your contention is this is going to add revenue to States, just to show how you get there and come up with a number that you project based on that analysis. Apparently I think that the States, the individual States—and I know NCSL and NGA have done a number of analyses, and they base it on certain assumptions, and we'll have to take a look at the reasonableness of those assumptions, but at least they have an analysis.

So I would welcome you to present this Committee a hard analysis of how it is that you think this change in law will increase revenue and exactly what you project it to be.

Mr. EHRHART. I'll be more than happy to do that.

Also, with respect to the Department of Revenue and their assumptions, as Mr. Delahunt did point out, we are the policymakers in our respective areas, and fortunately so, because generally the assumptions of State agencies don't always pan out.

I'm looking forward to being able to provide you with those cost-benefit analyses because those assumptions, I would be more than willing to stipulate, are based on one side of the equation and don't take into account the others. But I'm looking forward to presenting you with the other side and the overall balance.

Mr. VAN HOLLEN. I would like that because my experience—I was in the State Legislature of Maryland for 12 years, and we had a Department of Physical Services, actually did a very good job, and whose analyses were always closer to the mark with respect to the physical impact of legislation than the individual legislators, on both sides of the aisle, because they were drawn from a professional cadre of people who tried to look at the facts rather than just the ideology, again on both sides of the aisle. So I would welcome an analysis that shows that.

Thank you, Mr. Chairman.

Mr. CHABOT. Gentleman yield back? The gentleman's time has expired.

I want to thank the panel for their excellent testimony here this afternoon. Each and every one, I think, has done a very good job.

If there's no further matters coming before this Committee, we're adjourned. Thank you.

[Whereupon, at 2:30 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

RESPONSE TO POST-HEARING QUESTIONS FROM CAREY J. "BO" HORNE, PRESIDENT, PROHELP SYSTEMS, INC.

Responses to questions sent to Carey J. Horne on October 27, 2005 by the Subcommittee on Commercial and Administrative Law regarding testimony provided at the BATSA hearing on September 27, 2005.

1. Total Gross Receipts, as reported on our Federal tax returns, were:

2002	$118,055
2003	99,684
2004	99,604

2. We have paid $2,800 in legal fees to date for the Administrative Appeals portion of the process. Our attorney discounted the rate and did everything possible to keep the fees down. New Jersey has rejected every one of the Constitutional claims we believe are clearly valid. We now have no choice for protecting our rights other than to sue the State of New Jersey. That is a ridiculous position for any **home-based** business to be subjected to.

3. Before I answer the direct question, I want to reject a portion of the hypothesis of the question.

We contest the right of **any** State to impose taxation when no physical presence exists or where the activity is de minimis. In our case, **both** factors existed.

We are a **home-based** business with total receipts, as shown above, of approximately $100,000 per year **before** any overhead is incurred. We are truly a small business. No small business, including ones much larger than ours, can possibly be familiar with the widely-varying and ever-changing laws of 50 States. It is simply impossible, and it is precisely for this reason the Supreme Court established the physical presence standard in the Quill decision. It is no more practical for us to contend with **any** of the plethora of business taxes asserted by the various States than it is for us to deal with the broad variety of sales tax methods, rates, exceptions, and nuances.

Thus, we contend that, as a practical matter and as a matter of simple fairness, a strong physical presence standard must be adopted. Failure to do so jeopardizes the very ability of millions of small businesses to participate in Interstate Commerce.

Further, the Supreme Court has consistently held that taxation cannot be applied against de minimis activity. With total New Jersey sales of $6,132 over the six year period 1997-2002, certainly our activity was de minimis. Because neither the Supreme Court nor the Congress has set a standard for de minimis activity, New Jersey sets its own: **zero**, which is obviously not what the Court intended.

And, even further related to our specific situation, the Supreme Court held in the Quill decision (see Quill footnote 8 below) that the presence of a few software licenses does not meet the "substantial nexus" requirement of the Commerce Clause. Surely the seven licenses we sold in that six year period were far less than the "few" Quill had issued.

Thus, we reject the right of any State to assert taxation against businesses where no physical presence exists or where the activity is de minimis.

Now to answer the question as presented. My grandfather had a saying that applies very well to our situation. "Fool me once, shame on you. Fool me twice, shame on me." The Founding Fathers created our Federal system with the specific knowledge the States would be incubators for new ideas. We have seen that happen numerous times in our history; and it would be imprudent to assume that such incubation would not continue to occur, especially with regard to taxation.

In fact, unless the Congress acts to stop it, New Jersey has identified a perfect annuity system. **Identify one license sale (of any type, not just software) for any amount, collect $600 every year forever.** And, they can't be stopped because, practically speaking, the tax applies only to out-of-State businesses which have **no** representation in the matter, **at all**, except in the Congress.

We have been told by multiple prominent nexus attorneys that other States are, in fact, enforcing laws similar to those of New Jersey. We don't have details, because again, it is **impossible** for us to be familiar with them all. But, we know that other similar environments do exist; and it is prudent for us to assume they will continue to grow and become more pervasive and abusive until the Congress acts to stop such practices against small businesses.

We have therefore concluded that we, as small business owners, cannot accept the huge risks of continuing to make Interstate sales as we have in the past. We have therefore reduced our participation in Interstate Commerce through the elimination of our National advertising as we attempt to focus on South Carolina and Georgia markets. So far, we have faced a difficult time in doing so; and we are considering terminating our business completely.

Most small business owners are totally unaware of the substantial dangers they face. But no **prudent** small business owner, once he becomes aware of the realities of today's taxation climate, will continue to expose himself to the whims of 50 States. **As Mr. Delahunt has already indicated, my case is an egregious example; and it must be addressed.** We beg the Congress to protect all small businesses before they have to make the same terrible decisions we have had to make. Our Country simply cannot afford to lose such a vital portion of our economy.

Footnote 8 of the Quill decision:

In addition to its common carrier contacts with the State, Quill also licensed software to some of its North Dakota clients. See supra n. 1. The State "concedes that the existence in North Dakota of a few floppy diskettes to which Quill holds title seems a slender thread upon which to base nexus." Brief for Respondent 46. We agree. Although title to "a few floppy diskettes" present in a State might constitute some minimal nexus, in National Geographic Society v. California Bd. of Equalization, 430 U.S. 551, 556 (1977), we expressly rejected a " `slightest presence' standard of constitutional nexus." We therefore conclude that Quill's licensing of software in this case does not meet the "substantial nexus" requirement of the Commerce Clause.

SUPPORTING COMMENTS FOR H.R. 1956, THE "BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005," FROM CAREY J. "BO" HORNE, PRESIDENT, PROHELP SYSTEMS, INC.

October 4, 2005

The Honorable Chris Cannon
The Honorable Melvin Watt
House Judiciary Subcommittee on Commercial & Administrative Law
B-353 Rayburn HOB
Washington, DC 20515

Re: Supporting comments for hearing on H.R. 1956, "The Business Activity Tax Simplification Act of 2005" ("BATSA")

Dear Chairman Cannon and Ranking Member Watt:

I am sorry you were unable to attend the hearing last week during which I testified about the Nexus Nightmares small businesses are encountering as numerous States begin imposing business activity taxes based on 'economic nexus'.

I won't re-hash the details here, but it is imperative to get into the record some critical information that I, as an independent small businessman with no research staff, simply did not have time to compile before submitting my written testimony.

Two new important pieces of information are included herein to support the need for the critically-needed protections BATSA will provide to small businesses:

- **Economic Nexus Creates Nexus Nightmares for Small Businesses -** provides **numerous** one-line examples of **common** nightmares almost every small business is exposed to today. **Some don't even require sales in order to be imposed.**

- **The New Taxation Theory of Economic Nexus - Today's Version of Discriminatory Freight Rates? -** shows how the use of business activity taxes will hurt small and growing States in much the same way discriminatory railroad freight rates depressed the South and West for decades.

More than ever, thousands of small businesses desperately need your help. I urge each of you to provide strong support and leadership for prompt passage of this bill.

Sincerely,

Carey J. Horne
President
ProHelp Systems, Inc.
418 East Waterside Drive
Seneca, SC 29672

Economic Nexus Creates Nexus Nightmares for Small Businesses

What is nexus? States say you have nexus if you are "doing business there". Each State defines nexus totally differently (that is one of our problems!), but once a State declares that you have it, you are subject to the entire variety of taxes that State imposes. **The vast majority of small businesses assume they are doing business in their home State only.** Many States think otherwise, and there are a variety of major traps that easily create "**nexus nightmares**" for small businesses.

All but a few small businesses are totally unaware of these traps. Some do not even require that an interstate sale be made! They are simply a time bomb waiting to trap *all* small businesses in *every* State.

Once nexus is triggered for ***any*** reason, appropriate registrations and fees must be submitted promptly and applicable tax returns must be timely filed to prevent penalties and interest that can grow quickly to exceed the tax due. Some States don't even recognize the S Corporation election, and others require you to file the same return as Bill Gates! All of the rules vary ***widely*** by State; but if the customer happens to be in New Jersey, any sale of any type, such as a small box of paper clips, may trigger an immediate liability of $600, ***continuing every year until critical steps are taken to terminate nexus.***

State tax administrators have explicitly indicated they will impose taxation on a business if that business merely performs one of these common activities[2]:

- **35 States:** Any sale in the State is risky as no well-defined standard protects de minimis activity.
- **Michigan, New Jersey, Ohio, and Texas:** ***Anything*** is sold in the State; ***the protections of the Interstate Income Tax Act of 1959 (Public Law 86-272) don't apply!***
- **14 States:** A website is simply hosted on a server within the State; ***making sales through the website is not a requirement!*** No business has any idea where its hosting server is located until it asks its provider; every small business should ask now!
- **16 States:** A truck drives through the State, ***without even stopping.***
- **28 States:** An agent is used to check the creditworthiness of customers in the State.
- **New Jersey:** An agent is used to make sales in the State.
- **11 States:** A small sale is made at a trade show in the State.
- **7 States:** A registration of some type is filed with the State.
- **12 States:** A telephone number is listed in a directory in the State.
- **4 States:** A bank account is opened in the State.
- **7 States:** A loan is negotiated with or obtained from a bank in the State.
- **34 States:** Intangible property, such as licensed software, is sold in the State.
- **Minnesota:** If a healthcare provider outside Minnesota solicits for healthcare services within Minnesota, but provides the actual service in **another** State, nexus is created in Minnesota. This trap applies directly only to healthcare providers, which are generally large businesses. But, it can limit the availability, and increase the price, of healthcare which is probably the largest issue facing small businesses in ***all*** States today.

2. 2005 BNA survey of 47 State Departments of Revenue

The New Taxation Theory of Economic Nexus

Today's Version of Discriminatory Freight Rates?

For many years, the South suffered from the economic effects of discriminatory railroad freight rates. Northern States, being more populous and growing with immigrants, used the power of the Congress to protect their emerging industrial base with laws that allowed, or even required, railroad freight rates to be lower for shipments from North to South than from South to North.

Many argue this policy is largely responsible for the worst of the South's problems today – education, poverty, economic growth, and the history of racial discrimination. Being substantially agrarian, the South was unable to grow its economy for many years as the higher rates for Northbound shipments made economic growth and social change difficult or impossible.

In 1945, the 13 southern states had 28 percent of the nation's population and more than 40 percent of its natural resources. Yet they produced only 10 percent of the nation's manufactured goods.[1] With Northern markets effectively closed to Southern shippers by discriminatory rates, business was unable to diversify, emerge, grow, or prosper until the latter half of the twentieth century when discriminatory rates were declared an illegal hindrance to Interstate Commerce.

The degree to which the discriminatory rates protected Northern markets is clearly visible today. After the discriminatory rates were removed, the Southern economy has grown, prospered, and diversified. Without question, much work remains to be done; but also without question, much has been achieved in many area

Today, small and economically disadvantaged States are faced with a new version of the discriminatory and illegal freight rates. All States are desperate for revenue, but some have become downright greedy with a new approach to taxation called ***Economic Nexus***. ***Under this theory, businesses incur States tax liabilities simply for selling their products and services across State lines, even when no physical presence exists in the receiving State.***

In 1959, Congress passed the Interstate Income Tax Act. For almost 50 years, this Act has been a vital foundation of Interstate Commerce. It provides that a business in State A can ship tangible products into State B without creating income tax liabilities in State B, provided the business has no "physical presence" (buildings, employees, inventories, etc) in State B other than for the solicitation of sales.

Many businesses, especially small businesses, assume, perhaps even implicitly, that this protection is simply a given. It is not. The Act does not provide ***any*** protection for intangible products, such as software, copyrights, and trademarks, or for services. Further, the Act applies only to income taxes.

While intangible products and services did not represent much of our economy in 1959, they certainly do today. As a result, many States, particularly large ones envious of successful economic activity in other States, have begun to utilize the new approach of economic nexus to impose a variety of complicated and counter-productive business taxes on businesses located elsewhere. And some States, such as New Jersey, try to circumvent the Act and assert tax against ***all*** income or gross receipts attributable to customers located in their State.

The results are certain to mimic those of discriminatory freight rates the South and West endured for so many years. Many small and less economically successful States, such as South Carolina, Alabama, and Mississippi, are desperately promoting business growth, even using a variety of tax incentives. But, the businesses being attracted need the volume available through Interstate markets to justify their investments. The markets provided within the attracting States are simply insufficient to support the new businesses.

Though new businesses will bring jobs, the incentives offered to attract those jobs represent a huge cost. And, if the new approach of economic nexus continues to grow, the income taxes generated by the new businesses and expected to offset the costs of the incentives will become non-existent. ***They will be consumed both by administrative costs of businesses having to comply with a taxation system far more complicated than we already have today and by tax revenues effectively exported to greedy States using economic nexus to assert taxation against goods and services merely shipped into their States.***

The small and growing States will thus be left with the worst of all worlds: growth and more jobs, but insufficient revenues to cover the costs of infrastructure and quality of life improvements demanded by the new businesses, new residents, and general growth.

Further, the effects of the new approach of economic nexus are absolutely disastrous when applied to small businesses (see above page for examples). How can any small business comply with the widely varying and ever changing laws of 50 States? And, once localities begin using this theory, the problems will be truly astronomical.

Taxation justified by theories of economic nexus is simply a re-emergence of the same phenomenon that created discriminatory railroad freight rates: Large, perhaps even declining, and greedy States once again want to protect their own businesses and gain revenues at the expense of smaller States.

This problem will be completely eliminated by a bill now in the Congress. HR 1956, the Business Activity Tax Simplification Act of 2005 (BATSA), will update the Interstate Income Tax Act of 1959 to apply to ***all sales*** (tangible, intangible, and services) and to prohibit all types of business activity taxes being justified under theories of economic nexus.

1 http://freepages.history.rootsweb.com/~cescott/freight.html

RESPONSE TO POST-HEARING QUESTIONS FROM LYNDON D. WILLIAMS, TAX COUNSEL, CITIGROUP CORP.

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November 10, 2005

Brenda Hankins
Subcommittee on Commercial and Administrative law
House Judiciary Committee
B353 Rayburn HOB
Washington, D.C. 20515

Dear Ms. Hankins:

Please allow me to thank you and the members of the Subcommittee on Commercial and Administrative Law for the opportunity to testify before the Subcommittee on September 27 on H.R. 1956, the Business Activity Tax Act of 2005. These are very important issues for both the states and the business community. I am delighted to respond to the additional questions from the Subcommittee that were submitted to me by Chairman Cannon in his letter of October 27, and to be of assistance in anyway possible in this matter.

In response to question number one, Citicorp's move to South Dakota was based on several factors. In the late 1970s, the prime rate was at historic highs. Under the laws of New York State at that time, lenders were prohibited from lending to consumers at rates that exceeded certain percentages. Citicorp, like many other lenders, determined that it needed the flexibility to make loans in a way that was profitable. South Dakota's laws afforded a more favorable climate for lenders. Secondary to the flexibility afforded by the state laws, South Dakota's labor market provided an educated, productive and highly motivated workforce that was significant in the decision.

With regard to state taxes, at the time of the move, South Dakota had a relatively high tax rate of 6 percent applied to first earnings, and less than favorable apportionment rules that caused credit card companies to apportion income wholly to the state for tax purposes. States such as Nevada, Vermont, and Delaware would probably have provided more favorable tax environments. Therefore, I believe South Dakota's favorable regulatory and business climate provided the company with a much greater motivation for locating the business than did the state's tax regime.

In response to question number two, South Dakota tax laws, like many other states, require credit card income to be attributed to the state based on cost of performance standards. Under this standard, close to 100 percent of Citibank South Dakota's income is derived from South Dakota.

Question three inquires as to whether the actions of any state asserting tax jurisdiction based on economic activities have been successfully challenged in court. It is my understanding that litigation of tax jurisdictional issues involving financial institutions is pending at the trial and appellate court levels in Minnesota, Indiana, Massachusetts,

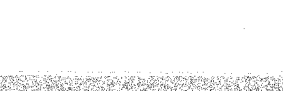
Alabama, West Virginia, and possibly Tennessee. The economic nexus standard asserted against a financial institution was successfully challenged in J.C. Penny National Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999) *cert. denied*, 121 S. Ct. 305 (2000 (citation). In that case, Tennessee's Commissioner of Revenue attempted to impose franchise and excise taxes on an out-of-state bank that had no office, no employees, and no tangible property in the state. Tennessee asserted economic presence based on J.C. Penny's solicitation and service of in-state credit cardholders. The Court of Appeals held that J.C. Penny's credit card activities did not constitute substantial nexus and that the company lacked the physical presence required by the Commerce Clause. The Court rejected the Commissioner's argument that Quill's physical presence standard does not extend to business activity taxes. The court found no reason why the application of the Commerce Clause analysis should be different for sales/use tax and business activity tax.

In response to question four, Citigroup has worked and continues to work closely with states and other governments in addressing issues that are important to states and to the business community. For instance, just last year we successfully lead a coalition of state and industry representatives in crafting legislation to resolve tax issues that were very important to the state of California and to the business community. The comprehensive bi-partisan legislation (A.B. 263) was unanimously approved by both houses of the state legislature and signed into law by the Governor (see letter dated October 22, 2004 from State Senator Dede Alpert (Democrat, San Diego). However, we do not believe that the constitutional issue of business activity tax jurisdiction lends itself to the kind of process as the Streamlined Sales Tax Project. The SSTP process comes as the result of the U.S. Supreme Court's decision in Quill Corporation v. North Dakota, 504 U.S. 298 (1992), which prohibits a state from forcing out-of-state vendors, without physical presence, to collect sales/use tax. The court's decision placed the states in a position in which they must simplify their systems if retailers are to assume collection responsibility, and the only manner for this to occur is through development of a consensus between the states and the retailer community.

While a multi-year collaborative process may be appropriate for addressing complex administrative issues such as those that are at the heart of the multi-state sales and use tax problem, the BAT nexus debate raises more fundamental, non-administrative issues relating to tax jurisdiction. This question of jurisdiction should be resolved by Congress, under the commerce clause, based on the principle that either tax jurisdiction exists or it does not exist – based on a single constitutional standard. The SSTP process, unlike the clarification of a BAT standard, is concerned with differing definitions, differing rates, differing exemptions, differing returns and filing periods, etc. These matters are voluminous and time consuming, and will only be resolved through a long-term collaborative process.

Thank you again for the opportunity to elaborate on these issues.

Sincerely,



PREPARED STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) appreciates the opportunity to comment to the House Judiciary Subcommittee on Commercial and Administrative Law on H.R. 1956, the Business Activity Simplification Act, which ABA strongly supports.

ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

H.R. 1956 would apply a uniform standard to an emerging multiplicity of state taxation laws affecting businesses that offer services or products in more than one state. An increasing number of states have passed or are considering passing legislation lowering the threshold of what constitutes a "substantial nexus" of business activity. Each state defines and applies their own nexus to determine when a business operating from another state is required to pay income tax in their state. Some state legislatures have concluded that just one customer residing in their state should count as a sufficient nexus for them to apply business income tax to a business operating from another state.

H.R. 1956 would codify in federal law that an actual physical presence in a state is required to create a substantial nexus. H.R. 1956 also includes 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.

Clearly, additional taxes cost businesses revenue they could otherwise invest in employees, innovation, or to better serve their customers. However, inconsistent standards adopted by multiple states compound the problem by creating business uncertainty, increasing litigation costs, and driving up compliance costs. HR 1956 would reduce these compliance and legal costs, and provide the certainty that the financial services industry needs to operate efficiently. It is also important to note that many smaller companies, such as community banks, do not possess the substantial resources required to comply with a proliferation of disparate state tax laws and as a result suffer disproportionately. There are more than 3,200 banks and thrifts with fewer than 25 employees; nearly 1,000 banks and thrifts have fewer than 10 employees. Many of these community banks operate near state borders and serve customers from more than one state.

Without business certainty, financial service providers are forced to offer fewer products at higher costs. Financial service providers might also cease doing business in those states where additional tax burdens exist. Therefore, states that aggressively tax out-of-state businesses could have the effect of reducing choices available to consumers in those states. Reduced competition would restrict consumer access to credit and increase credit costs in those states, which could have even broader negative effects on individual state's economies and, possibly, the economy of a larger region.

For example, almost all large consumer purchases (e.g., cars, homes, boats, etc.) are accomplished through the use of loans. A growing number of everyday purchases are performed with credit cards. Many of these services are offered by banks located outside of one's home state or by banks located in multiple states. Healthy national competition for customers ensures that customers receive the highest quality products at the best prices. But when banks or credit card companies discontinue or restrict their services to a particular state, local consumers and citizens have fewer options for obtaining credit and less access to innovative products. This depresses economic growth and ultimately hurts the state tax receipts of business actually located within the affected jurisdiction.

ABA is grateful to Congressman Goodelatte and Congressman Boucher for re-introducing the Business Activity Simplification Act in the 109th Congress and Chairman Cannon for holding a hearing on this important legislation. We look forward to working with the Committee on this important legislation.

PREPARED STATEMENTS OF MICHAEL MAZEROV, SENIOR FELLOW, ON BEHALF OF THE CENTER ON BUDGET AND POLICY PRIORITIES

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Revised September 29, 2005

FEDERAL "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION:

HALF OF A TWO-PRONGED STRATEGY TO GUT STATE CORPORATE INCOME TAXES

By Michael Mazerov

Background and Summary

Major multistate corporations are engaged in a two-pronged strategy aimed at substantially increasing the share of their nationwide profit that is not taxed by any state. The strategy involves the enactment of complementary state and federal legislation. The state legislation — which corporations have already succeeded in enacting in 12 states and are actively seeking in close to a dozen more — is aimed at lowering the corporate taxes of in-state corporations and shifting these taxes onto out-of-state corporations. The federal legislation, which corporations have been seeking since 2000, would make it much more difficult for states to require many out-of-state corporations to pay *any* income tax. Together, the two changes in tax law would create a "heads I win, tails you lose" system of state corporate income taxation — with corporations the winners and states the losers.

The latest version of the federal legislation is H.R. 1956, the "Business Activity Tax Simplification Act of 2005." Its lead sponsors are representatives Bob Goodlatte and Rick Boucher. Like its predecessors, H.R. 1956 would impose what is usually referred to as a federally-mandated "nexus" threshold for state (and local) "business activity taxes" (BATs). State taxes on corporate profits collected by 45 states and the District of Columbia are the most widely-levied state business activity taxes and are the focus of this report. (The term also encompasses such broad-based business taxes as the Michigan Single Business Tax — a form of value-added tax — and the Washington Business and Occupations Tax — a state tax on a business' gross sales.) The "nexus" threshold is the minimum amount of activity a business must conduct in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State laws levying a tax on a business will set forth the types of activities conducted by a business within the state that obligate the business to pay some tax (which usually is proportional to the level of activity in the state). If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must pay the tax. Federal statutes can override state nexus laws, however, and H.R. 1956 proposes to do so in four key ways:

- H.R. 1956 declares that a business must have a "physical presence" within a state before that jurisdiction may impose a BAT on the business. This provision would nullify many state laws that assert that a non-physically-present business establishes nexus with the state when it makes economically-significant sales to the state's resident individuals and/or businesses. In establishing this true, "physical presence" nexus threshold, H.R. 1956 would resolve in favor of business a lingering question as to whether state laws declaring nexus to be created by sales alone are valid under the U.S. Constitution.

- Under H.R. 1956, however, some businesses could have a physical presence in a state *without* creating nexus. The bill would create a number of nexus "safe harbors." These are categories and quantities of clear physical presence that a corporation or other business could have in a state that nonetheless would be deemed no longer sufficient to create BAT nexus for the business. For example, the bill allows a corporation to have an unlimited amount of employees and property in a state without creating nexus, so long as neither are present in the state on more than 21 days within a particular year.

- H.R. 1956 substantially expands an existing nexus "safe harbor," federal Public Law 86-272. P.L. 86-272 provides that a corporation cannot be subjected to a state corporate income tax if its only activity within a state is "solicitation of orders" of tangible goods, followed by delivery of the goods from an out-of-state origination point. The protected "solicitation" may be conducted by advertising alone or through the use of traveling salespeople. H.R. 1956 would expand the coverage of P.L. 86-272 to the entire service sector of the economy and apply it to all types of BATs, not just income taxes.

- H.R. 1956 would impose new restrictions on the ability of a state to assert BAT nexus over an out-of-state corporation based on activities conducted within its borders by a (non-employee) individual or other business acting on behalf of the out-of-state business.

In short, H.R. 1956 is intended to substantially *raise* the nexus threshold for corporate income taxes and other BATs — that is, to make it much more difficult for states to levy these taxes on out-of-state corporations.

The fact that state corporate income tax nexus thresholds would be raised by H.R. 1956 means that the profits of particular corporations would no longer be subject to tax in particular states. While that may raise equity concerns, it does not inherently mean that the states as a group would lose corporate income tax revenue. In fact, however, many of the same corporations pushing for the enactment of legislation like H.R. 1956 at the federal level are lobbying at the state level for complementary changes in state corporate income tax laws. These state laws *would* ensure that the enactment of legislation like H.R. 1956 would result in a substantial corporate tax revenue loss for states in the aggregate:

- Multistate corporations are lobbying in numerous states for a switch to a so-called single sales factor apportionment formula. (They have already obtained enactment of the single sales factor formula in 13 states.) Apportionment formulas embedded in each state's corporate income tax law determine *how much* of a multistate corporation's nationwide profit is subject to tax in a state in which it *does* have nexus. If a corporation makes 10 percent of its sales to customers in a single sales factor state, then 10 percent of its nationwide profit will be subject to tax in that state.

- Under a single sales factor formula, a corporation that produces all of its goods in a state but has all of its customers in other states will have *no* corporate income tax liability to the state in which it does its production. However, if this same corporation did not have nexus in its customers' states, because the activities it conducted in those states would be deemed no longer nexus-creating under H.R. 1956, then *all* of this corporation's profit would become "nowhere income" — profit not subject to tax by *any* state.

- In reality, of course, most corporations do have at least some customers in the states in which they produce their goods and services, and even under legislation like H.R. 1956 they would often have nexus in some of the other states in which their customers are located. So most multistate corporations would continue to pay some state corporate income taxes even if legislation like H.R. 1956 were to be enacted.

- Nonetheless, if the state corporate income tax nexus threshold were raised sharply by new federal legislation, and if multistate corporations continue to make progress in their campaign to get large industrial states to switch to a single sales factor formula, the two policies would interact in a way that would vastly expand the share of total nationwide corporate profit that escapes taxation entirely.

The creation of more "nowhere income" is a major goal of the multistate corporate community in seeking the enactment of bills like H.R. 1956, notwithstanding claims that the legislation is only intended to regulate *which* states can tax a corporation and not to affect the aggregate taxation of corporate income. The evisceration of state corporate income taxes — the source of $28 billion in annual revenue — would harm states already struggling to provide adequate education, health, and homeland security-related services.

It is not at all clear that congressional action to clarify and harmonize state BAT nexus thresholds is warranted, but if Congress is determined to act, viable alternatives to bills like H.R. 1956 are available that would do less damage to state finances. Congress could implement the proposed model nexus threshold carefully crafted by the Multistate Tax Commission, which would base the existence of BAT nexus on relatively objective measures of the amount of a corporation's property, payroll, or sales present in a state.

Two Leading State Tax Experts Debunk "Taxation without Representation" Argument Offered in Support of BAT Nexus Legislation

Disingenuous Corporate Rhetoric

Among the many arguments proponents offer in support of BAT nexus legislation is the claim that the legislation is needed to stop states from imposing unfair corporate tax burdens on out-of-state corporations with minimal physical presence within their borders. States are accused of engaging in "taxation without representation" — targeting for excessive taxation out-of-state businesses that have little political influence in states in which they have few if any employees.[1] (See the text box on page 4 for a debunking by two leading state tax experts of the "taxation without representation" argument.)

Charges of excessive state taxation of out-of-state companies are disingenuous in light of the fact that multistate corporations throughout the United States — including some of the same corporations that support H.R. 1956 (and/or its predecessors) — have been lobbying at the *state* level for a change in state corporate tax policy that *intentionally* targets out-of-state businesses for heavier taxation. In more than a dozen states, individual corporations and the trade associations to which they belong have lobbied recently for state adoption of a "single sales factor apportionment formula" for the state corporate income tax. This policy change is intended to shift the corporate tax burden off of corporations that have a significant physical presence in a state and onto corporations that have relatively little physical presence there.

The apportionment formula embedded in every state's corporate income tax law determines the share of a multistate corporation's nationwide profit upon which the state imposes its tax. The *traditional* formula is written in such a way that the more property and employees a corporation has in a state — that is, the more substantial is its physical presence — the greater the share of its nationwide profit that is subject to tax in the state and therefore the greater its tax payment to that state.

The single sales factor formula is intended to reverse this policy of subjecting corporations to higher income tax burdens the greater their physical presence in a state. When a state switches to a single sales factor formula, a corporation with substantial headquarters and/or production facilities in a state but most of its sales elsewhere is likely to experience a sharp drop in its corporate income tax liability to that state. In contrast, an out-of-state corporation with corporate income tax nexus in that state, significant sales in that state, and little (if any) permanent physical presence in that state is likely to experience a sharp increase in its corporate tax payment. In fact, since the single sales factor formula bases a corporation's tax liability to a state solely on in-state sales, a corporation with no customers in the state in which it does its production would see its corporate tax liability in that state drop by 100 percent — to zero — if the state switched to a single sales factor formula.[2] Overall, adopting a single sales factor formula tends to automatically shift the adopting state's total corporate tax burden off of in-state corporations with substantial facilities but relatively few sales in the state and onto out-of-state corporations in the opposite situation.

In the last decade, nine states have switched from some variant of the traditional apportionment formula to a single sales factor formula.[3] In every case this change was urged on the state by major multistate corporations having a substantial physical presence within its borders. Moreover, the multistate corporate community continues to seek enactment of a single

sales factor formula in numerous other states, including such major manufacturing centers as Arizona, California, Indiana, New Jersey, and Pennsylvania.

Individual multistate corporations are often reluctant to publicly endorse enactment of the single sales factor formula, preferring to leave the public face of the lobbying effort to their trade associations or state chambers of commerce. A few corporations have been exposed as having lobbied for enactment of the single sales factor formula in states in which they have a substantial physical presence — and therefore would receive a tax cut — and lobbied against it in states in which they have little physical presence and therefore would experience a tax increase. By leaving the public endorsement of single sales factor legislation to their membership organizations, multistate corporations retain the flexibility to take these contrary lobbying positions without opening themselves up to criticism for their inconsistency.[4]

A small number of individual corporations that have publicly endorsed or lobbied for state adoption of a single sales factor formula in recent years can be identified, however:

- Lobbying reports filed with the Secretary of State's office in California reveal that the membership of the "Business for Economic Growth in California" coalition that has lobbied for single sales factor legislation there in recent years has included Apple Computer, Chevron, Cisco Systems, Intel, Occidental Petroleum, Oracle, Sony, Texaco, Disney, and Sun Microsystems.[5]

- In Arizona, supporters of proposed single sales factor bills include AT&T, American Express, Honeywell, Boeing, Intel, and Goodrich/Raytheon.[6]

- In Oregon, members of the Smart Growth Coalition lobbying for single sales factor legislation included Intel, Nike, Adidas, Columbia Sportswear, and Tektronix.[7]

- In Georgia, corporations lobbying for single sales factor legislation in 2005 included BellSouth, Coca-Cola, General Electric, and Georgia-Pacific.[8]

Several of these corporations that recently have supported state adoption of single sales factor formula also support the enactment of H.R. 1956 and/or are members of organizations that supported similar BAT nexus bills introduced in earlier sessions of Congress:

- Apple Computer, Chevron, Cisco Systems, Sony, Disney, American Express, and Nike all signed a letter dated September 26, 2005 to House Judiciary Committee Chair Jim Sensenbrenner endorsing H.R. 1956.

- Senior tax staff of American Express, Chevron, AT&T, General Electric, Coca-Cola, Bellsouth, and Cisco Systems are currently on the board of the Council on State Taxation, an organization that represents over 500 major multistate corporations on state tax policy-related issues. COST supported H.R. 3220, the version of the BAT nexus bill introduced in the 108th Congress. H.R. 3220 and H.R. 1956 are virtually identical.[9]

- American Express, Cisco, Sony, and Disney have previously been identified as members of an ad hoc coalition organized to lobby for BAT nexus legislation.[10] The coalition recently changed its name to the Coalition to Protect Interstate Commerce (CPIC).

- Apple, Cisco, Oracle, and Sun were members of the "Internet Tax Fairness Coalition," a defunct organization that endorsed versions of BAT nexus legislation introduced in previous sessions of Congress.[11]

It also seems likely that many (if not all) of the corporations identified above as supporters of single sales factor legislation in California, Arizona, and/or Oregon are members of the Business Roundtable, National Association of Manufacturers, U.S. Chamber of Commerce, or the American Electronics Association, all of which signed the joint September 26, 2005 letter to Representative Sensenbrenner supporting the enactment of H.R. 1956.

In short, even as organizations to which they belong (or have belonged) denounce the states for allegedly imposing excessive and unfair tax burdens on out-of-state corporations with little physical presence within their borders and call for the enactment of H.R. 1956 or similar legislation to put a stop to this, more than 20 major multistate corporations are known to have lobbied at the state level for a policy that is *intended* to shift the corporate tax burden onto out-of-state corporations with relatively little physical presence within the state. In light of the fact that at least four corporations that are former or current members of CPIC are known to have worked for the enactment of a single sales factor formula in at least one state, it is even more ironic that CPIC's chief lobbyist has argued that federal BAT nexus legislation is needed *because* states have enacted this discriminatory formula:

> If a state has a . . . a single-factor apportionment formula based only on sales (which is increasingly popular among the states), in-state businesses enjoy a significant benefit over business that have little or no property or payroll in the state but that do have sales that are apportionable to the taxing state.
>
> When [a single sales factor formula is] combined with the economic nexus standard [which asserts the existence of nexus on the basis of significant in-state sales alone], states would actually be subsidizing such incentives for in-state businesses at the expense of out-of-state businesses that do not receive the benefits and protections provided by the state. Not only does this offend the basic principle of nondiscrimination that is required by the Commerce Clause of the U.S. Constitution but, in addition, it surely is misguided tax policy to make one party that is not really "in" the jurisdiction bear the tax burden of those persons who actually receive the benefits and protections of the government services that the taxes are funding.[12]

CPIC's lobbyist is correct; the single sales factor formula *is* discriminatory tax policy. In violation of the "benefits received" principle of taxation, it imposes an excessively large share of a state's corporate tax burden on corporations benefiting less from public services in the taxing state than the corporations with a substantial physical presence in the state whose tax burden the

formula lightens.[13] The solution is to solve the problem directly by discouraging states from switching to the formula or even, perhaps, banning it through federal legislation. (See the text box on page 11 for discussion of how another key argument offered by CPIC's lobbyist in support of BAT nexus legislation like H.R. 1956 is inconsistent with the pursuit at the state level of a single sales factor apportionment formula by members of his own organization.)

Rational Self-Interest: Evisceration of the State Corporate Income Tax

While it is disingenuous of business representatives to justify their support for BAT nexus legislation on the basis of alleged state discrimination against out-of-state corporations at the same time they are lobbying at the state level for precisely that discrimination, in reality they are pursuing their self interest in a quite rational manner. Widespread enactment of a single sales factor formula at the state level and the enactment of federal BAT nexus legislation are two complementary prongs of an attack on the corporate income tax aimed at eviscerating this much-despised (by corporations) source of state revenue.

When a state decides to switch from the traditional property-payroll-sales apportionment formula to a single sales factor formula, it is choosing to relinquish its ability to obtain substantial tax payments from its in-state corporations in favor of making out-of-state corporations pay more. The switch is likely to lead to a net loss of revenue for the state even under current law; many of the out-of-state corporations with substantial sales in the state that the single sales factor formula would ordinarily compel to pay more are completely exempt from tax due to the protection from establishing nexus provided by Public Law 86-272.

The enactment of a federal bill like H.R. 1956, however, would likely magnify the revenue loss from the switch to a single sales factor formula several times over.[14] Due to all the new "safe harbor" provisions in H.R. 1956, an even larger group of corporations would be protected from having nexus in states in which they have relatively little physical presence but make substantial sales. For example, H.R. 1956 would expand P.L. 86-272 to cover all multistate service businesses, like banks and television networks. H.R. 1956 also would eliminate the taxability in a state of many out-of-state businesses whose presence within the state is limited to sending in employees to interact with customers on a short-term basis, such as companies that provide on-site installation and repair of the equipment they sell.[15]

By making it much more difficult for states to assert income tax nexus over out-of-state corporations with relatively little or only temporary physical presence within their borders, the enactment of a bill like H.R. 1956 would largely solve the paradox of corporate support for the single sales factor formula. Corporations that tend to serve regional or national markets from production locations in only a few states — such as manufacturers — are the primary beneficiaries of the single sales factor formula; the adoption of the formula generally provides tax reductions to such corporations in the states where they are headquartered and/or produce their wares. However, the very same corporations would face tax increases in the states in which they make most of their sales but do no production if those states *also* switched to the formula. The paradox of corporate support for the single sales factor formula is that the more successful corporations are at convincing the states in which they produce their goods and services that

switching to the formula is good for economic development, the more likely it is that corporations based in all the other states will convince *their* state governments that they must adopt the formula for the same reason. If every state eventually switched to the single sales factor formula, corporations would lose most of their tax savings; the tax reductions in their "production states" would be substantially offset by tax increases in their "market states" (the states where their customers are located).[16]

The enactment of a bill like H.R. 1956, however, would transform corporate pursuit of the single sales factor formula from a potentially self-defeating strategy into a rational — indeed paramount — objective. Even as universal adoption of the formula slashed their corporate income tax liability in their production states, bills like H.R. 1956 would protect a large number of corporations from the higher tax liability they would otherwise experience in their "market states" if those states also adopted the single sales factor formula. (H.R. 1956 would render many of the corporations completely immune from income taxation in their market states.) Widespread adoption of a single sales factor apportionment formula by states levying a corporate profits tax, in combination with the enactment of a bill like H.R. 1956, would create a situation in which a substantial share of the aggregate profits of multistate corporations would be "nowhere income" — profit not subject to taxation by *any* state.[17]

In short, the effort by the multistate corporate community to enact federal BAT nexus legislation represents one side of a quite conscious strategy to eviscerate the state corporate income tax — with widespread or universal state adoption of the single sales factor formula constituting the other side. Corporate lobbying already has convinced nearly one-fourth of the states imposing corporate income taxes to adopt a single sales factor apportionment formula, and business organizations continue to seek enactment of the formula in nearly a dozen additional states — including such large ones as California and Pennsylvania. In light of these widespread, intensive, high-profile efforts to enact the single sales factor formula, claims by proponents of BAT nexus legislation that the bills do "not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the correct jurisdiction" cannot be taken seriously.[18]

With the bulk of corporate output in the U.S. economy covered by single sales factor apportionment rules and H.R. 1956 in place, state corporate income tax receipts would drop sharply; the corporations still relegated to paying the tax would mainly be small, wholly in-state corporations.[19] With those business clamoring about their unfair tax burdens relative to their out-of-state competitors, corporate tax revenues plunging, and the tax tied up in substantial litigation over the application of the numerous vaguely-defined or undefined terms in H.R. 1956, officials in many states might well decide that the revenues generated by the tax did not justify the costs, inequity, and conflict. Repeal of the corporate income tax in many states would be a distinct possibility — likely fueling repeal in other states due to economic competitiveness concerns. While such a scenario might not displease many corporate proponents of H.R. 1956, it would do considerable damage to state and local governments and the people who depend on them for education, health care, protection from crime, and scores of other essential services; the corporate income tax generated $28 billion in revenue in FY03.

Reasonable Alternatives to H.R. 1956 Are Available

It is debatable whether there is any need for a new federal BAT nexus law. Business activity taxes have been in place for over 50 years in most states, and multistate corporations seem to have managed to figure out in which states they are subject to them and in which states they are exempt. Despite claims by H.R. 1956 proponents that states are engaged in aggressive new efforts to assert nexus over out-of-state corporations, the vast majority of the disputes involve a single, highly abusive tax shelter employed by multistate corporations that states are justified in shutting down using every legal means at their disposal.[20] Even if Congress does decide it should enact new BAT nexus legislation under its authority to regulate interstate commerce, rational and fair alternatives to bills like H.R. 1956 are available. Congress could implement a proposed model nexus threshold carefully crafted by the Multistate Tax Commission, which would base the existence of nexus on relatively-objective measures of the amount of a corporation's property, payroll, or sales present in a state.[21] At a time when there is strong bipartisan support in Congress for shutting down tax shelters and closing loopholes that afflict the *federal* corporate income tax, it would be unfortunate and ironic if Congress enacted legislation like H.R. 1956 that would severely undermine the same — and equally-critical — source of revenue for states.

Another CPIC Argument in Favor of Federal Nexus Legislation Is Inconsistent with Its Members' Support for the Single Sales Factor Formula

Notes

[1] "Unfortunately, some state revenue departments have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on businesses located in other states that have little or no connection to their states. . . Such behavior is entirely logical on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state's society. But this country has long stood against such *taxation without representation*." Testimony by Arthur R. Rosen, representing the Coalition for Rational and Fair Taxation, in support of H.R. 3220, before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004. Emphasis added. H.R. 3220 was the version of BAT nexus legislation introduced in the 108th Congress; it is virtually identical to H.R. 1956.

[2] For examples of how a single sales factor formula affects the calculation of state corporate income tax liability relative to the traditional formula that includes property and payroll factors, see: Michael Mazerov, *The Single Sales Factor Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities, revised May 2005.

[3] Since 1994, Connecticut, Georgia, Illinois, Maryland, Massachusetts, Minnesota, New York, Oregon, and Wisconsin have adopted a single sales factor formula for manufacturers only or for all corporations. (Georgia, Minnesota, New York, and Wisconsin are phasing-in the single sales factor formula.) Iowa, Missouri, Nebraska, and Texas had adopted a single sales factor formula at an earlier date.

[4] The main justification offered by corporations for why states should switch to a single sales factor apportionment formula is that it is (allegedly) an effective incentive for economic development and job creation. If an individual corporation makes this argument in public testimony, the state adopts the formula, and the company then reduces its employment in a state (or chooses a non-single-sales factor state for a large investment), it runs the risk of public embarrassment. (For example, Black and Decker Corporation was a major proponent of Maryland's adoption of single sales factor and subsequently closed its manufacturing plants in the state, a fact noted by a number of columnists.) A desire to avoid the potential for such embarrassment likely is another reason why relatively few individual corporations can be identified as having lobbied for adoption of single sales factor in the many states in which business interests have sought its enactment in recent years.

[5] Form 635, "Report of Lobbying Coalition," filed with California Secretary of State with respect to AB 1642 and SB 1014, January 31, 2002. Same form filed August 2, 2004, with respect to AB 2590.

[6] Arizona Senate Caucus Calendar, March 16, 2004, SB 1143. Minutes of the Arizona Committee on Ways and Means, February 18, 2003, HB 2356.

[7] Minutes of the Oregon Senate Revenue Committee hearing on HB 2558, April 9, 2001.

[8] James Salzer, "$1 Billion Corporate Tax Break," *Atlanta Journal-Constitution*, March 4, 2005. Nancy Badertscher, "House OKs Business Tax Cut," *Atlanta Journal-Constitution*, February 9, 2005.

[9] The COST Web site (www.statetax.org) was visited on May 4, 2005 to obtain list of current board members. COST has adopted a formal policy resolution stating that enactment of a "physical presence" BAT nexus standard is a *quid pro quo* for expanded state authority to require non-physically-present merchants to collect and remit sales taxes (and vice-versa). COST has also adopted a second statement on what such BAT nexus legislation should contain. A spokesperson for COST wrote that H.R. 3220 satisfied all the requirements for BAT nexus legislation set forth in the policy statement, meaning that COST supported the enactment of H.R. 3220 in conjunction with legislation empowering states to impose their sales taxes on remote sales. See: Stephen Kranz, "COST Supports Federal Legislation with Carrot-and-BAT Approach," *State Tax Notes*, October 20, 2003. "Alone, H.R. 3220 meets the 'musts' and 'shoulds' of the COST Policy Statement on business activity tax nexus and has our support in that regard." Again, H.R. 3220 is virtually identical to H.R. 1956.

[10] Testimony of Arthur Rosen, representing the Coalition for Rational and Fair Taxation (CRAFT), on H.R. 2526, before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, September 11,

2001. H.R. 2526 was the version of the BAT nexus legislation introduced in the 107th Congress. CRAFT recently changed its name to the Coalition to Protect Interstate Commerce (CPIC).

[11] The membership list of the Internet Tax Fairness Coalition was still available on the Web as of May 4, 2005, at http://www.salestaxsimplification.org/members/default.htm. A letter dated June 4, 2001 posted at ITFC's Web site (http://www.salestaxsimplification.org/documents/Gregg_Allen.doc) expresses support for S. 664, a predecessor bill to H.R. 1956.

[12] Testimony in support of H.R. 3220 before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004.

CRAFT is not the only organization that has used state adoption of an unfair single sales factor apportionment formula to justify its support for BAT nexus legislation at the same time that its own members were lobbying for the formula in some states. The Chair of the (now defunct) Internet Tax Fairness Coalition said in a debate in December 2001: "[T]he states play games with that three-factor apportionment formula and then proceed to increase taxes on out-of-state businesses and reduce taxes on their in-state businesses. . . . |Y|ou've got states that are less populated and don't have as much business activity trying to finance the construction of their infrastructure on the backs of out-of-state businesses. And that's not fair, if you want to talk about fairness." ITFC Chairman Mark Nebergall, quoted in Doug Sheppard, "MTC Counsel, High-Tech Rep Debate Business Activity Tax Nexus," *State Tax Notes*, December 3, 2001. As noted in the body of this report, ITFC members Apple Computer, Cisco Systems, Oracle, and Sun Microsystems were all lobbying for the enactment of single sales factor legislation in California around the time that Nebergall made this statement.

[13] See Chapter V of the source cited in Note 2.

[14] Other commentators have noted that the enactment of federal BAT nexus legislation like H.R. 1956, combined with single sales factor apportionment, would lead to additional revenue losses for states: "The proposed legislation . . . would expand the scope for the creation of nowhere income, and thus aggravate the opportunities for tax planning and the revenue loss created by Public Law 86-272. This is especially true in states where sales are the only or primary factor used to apportion income — a rule that has been advocated by many of the same business interests that are seeking a physical presence nexus rule for BAT." Source: Charles E. McLure Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004. Elsewhere, Hellerstein has used somewhat more forceful language: "One of the most appalling notions or developments is that on the one hand, you have this idea that . . . if all you're doing is selling into a state without a physical presence there . . . there's no appropriate basis for imposing a business activity tax. . . . And in the next breath, "Oh, by the way, what's the right way to assign income? Based on where your sales are, regardless of whether you're there or not.' Something's rotten in Denmark. You can't have it both ways." Quoted in: Doug Sheppard, "What's the Appropriate Standard for Business Activity Tax Nexus?" *State Tax Notes*, March 4, 2002.

[15] For a more in-depth discussion of the ways in which H.R. 1956 would protect corporations from establishing nexus, 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, Revised May 9, 2005.

[16] The qualifier "substantially" must be used here because states do not all tax corporate income at the same rates and do not define taxable corporate income in the same way. Even if every state adopted a single sales factor formula, a corporation that was taxable ("had nexus") in every one of them might experience a net increase or reduction in its aggregate state corporate tax liability depending upon whether its sales were in states with relatively high or low tax rates. Interstate variation in the definition of taxable income could have the same effect.

[17] States can and do put certain "fallback" rules into their corporate income tax codes to ensure that if a corporation does not have nexus in a state to which its income is assigned by the apportionment formula, that income is taxed by a different state or states. These rules — technically known as "throwback" and "throwout" rules — are needed to prevent "nowhere income" even under current law, because Public Law 86-272 often protects corporations from

creating nexus in states in which they have substantial sales. The "throwback" rule, for example, effectively "throws back" to the state from which goods are shipped to their final customer any profits that the customer's state is barred from taxing. (See the source cited in Note 2 for a detailed discussion of the interaction of a single sales factor formula and the throwback rule.)

The adoption by all states of a single sales factor formula, combined with the enactment of a bill like H.R. 1956, would lead to substantial "nowhere income" notwithstanding state potential to implement "throwback" and "throwout" rules. The reasons for this are as follows:

- Only about half the states with corporate income taxes have any type of throwback or throwout rule in effect.

- Except for a handful of states, the throwback/throwout rules that *are* in effect only apply to sales of goods. Since H.R. 1956 would — for the first time — drastically limit the ability of states to assert nexus over physically-present sellers of services, many states would have to enact a throwback/throwout rule covering services to prevent H.R. 1956 from creating vast amounts of untaxed profits for service businesses.

- Almost no states have in effect a throwback/throwout rule that applies to personnel and property. Since H.R. 1956 would enable some corporations to have substantial amounts of personnel and property in another state without creating nexus there (see the Appendix of the source cited in Note 15), substantial "nowhere income" would be created if states did not enact throwback rules for payroll and property in addition to the conventional throwback rule covering sales.

- The multistate corporate community vehemently opposes throwback/throwout rules. In the last two years alone, corporations have successfully lobbied against two out of three serious attempts to enact these rules in states that had not previously done so.

- Procedural hurdles exist in a significant number of states that would make it quite difficult to enact throwback/throwout rules to protect state tax bases from the revenue-reducing effects of H.R. 1956. Once the legislation went into effect and revenues began to fall, enacting these rules to offset the revenue decline would be tagged as a "tax increase." In nearly a dozen states, all tax increases require supermajority approval in the state legislature. In two more, tax increases even require approval in a statewide referendum. Obviously, such requirements would make it even less likely that these rules could be enacted into state law.

[18] Testimony of Arthur R. Rosen, representing the Coalition for Rational and Fair Taxation, in support of H.R. 3220, before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004.

[19] A corporation with all of its sales, property, and employees in a single state is subject to taxation there of all of its income regardless of the apportionment formula adopted by the state.

[20] See the discussion of the Delaware intangible holding company tax shelter in the source cited in Note 15. See also: Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, Center on Budget and Policy Priorities, Revised May 21, 2003; Glenn R. Simpson, "A Tax Maneuver in Delaware Puts Squeeze on Other States," *Wall Street Journal*, August 9, 2002.

[21] See: Multistate Tax Commission, *Federalism at Risk*, June 2003, Appendix D: Factor Presence Nexus Standard. Available at http://www.mtc.gov/Federalism/FedatRisk--FINALREPORT.pdf.

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PROPOSED "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION WOULD SERIOUSLY UNDERMINE STATE TAXES ON CORPORATE PROFITS AND HARM THE ECONOMY

By Michael Mazerov

Highlights

A bill recently re-introduced in the U.S. House of Representatives would take away from states authority they currently have to tax a fair share of the profits of many out-of-state corporations. H.R. 1956, the "Business Activity Tax Simplification Act of 2005," was re-introduced in the 109th Congress on April 28, 2005 by Representatives Bob Goodlatte and Rick Boucher. No Senate counterpart to H.R. 1956 has been introduced.

H.R. 1956 defines many activities commonly conducted by corporations within a state as being no longer sufficient to obligate the corporation to pay several different kinds of taxes to the state (or to its local governments). Moreover, these "safe harbors" from taxation are defined in a highly arbitrary and inconsistent manner. These new restrictions on state and local taxing authority would have far-reaching, adverse impacts on the revenue-generating capacity and fairness of state and local tax systems. The most significantly affected taxes would be the corporate income taxes levied by 45 states, the District of Columbia, and New York City. If enacted, H.R. 1956 would have the following effects:

- The legislation would cause state and local governments collectively to lose substantial tax payments from out-of-state corporations that would be freed from their current obligations to pay taxes on their profits and gross sales to particular jurisdictions. A significant share of currently-taxable corporate profits would go untaxed by *any* state, leading to a net revenue loss for the states as a whole.

- H.R. 1956 would block particular states from taxing particular corporations on income earned in those states. Even if those corporations' profits might ultimately be taxed by their home states, H.R. 1956 still would unfairly deprive other states and localities of their right to tax the profits of specific out-of-state corporations that benefit from services these jurisdictions provide.

- H.R. 1956 would stimulate a wave of new corporate tax sheltering activity aimed at cutting state and local business taxes.

- The legislation would mire state and local governments and corporations alike in a morass of litigation over whether particular businesses are or are not protected

from taxation under the numerous vaguely-defined provisions of H.R. 1956.

- H.R. 1956 would reward major multistate corporations that have the resources to engage in aggressive tax-avoidance behavior with much lower tax burdens than their small, locally-oriented competitors.

For example, if H.R. 1956 were enacted:

- A television network would not be taxable in a state even if it had affiliate stations within the state relaying its programming and regularly sent employees into the state to cover sporting events and to solicit advertising purchases from in-state corporations.

- A bank would not be taxable within a state even if it hired independent contractors there to process mortgage loan applications and the loans were secured by homes located within the state.

- A restaurant franchisor like Subway or Dunkin' Donuts would not be taxable in a state no matter how many franchisees it had in the state and no matter how often its employees entered the state to solicit sales of supplies to the franchisees.

- A corporation in the business of providing on-site computer repair services could avoid taxation in every state in which its customers were located — except for its home state — by forming subsidiary corporations to employ its repair crews.

These are just a few examples of the types of corporations that would be protected from state corporate income taxes by the provisions of H.R. 1956. That corporations engaging in such extensive in-state activities would be immunized from taxation suggests why a congressionally-imposed BAT nexus threshold even loosely based on the current text of H.R. 1956 would be a prescription for further litigation, inequity among businesses, and erosion of a vital source of funding for state and local services.

A compelling case for federal intervention into BAT nexus issues at this time has not been made, but if Congress does decide to act in this area, workable and fair alternatives to H.R. 1956 are available. A proposed nexus standard developed by the Multistate Tax Commission, for example, would base the creation of nexus on relatively objective measures of the dollar amount of a business' sales occurring in a state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.[1] Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a BAT on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

What Would H.R. 1956 Do?

H.R. 1956 would impose what is usually referred to as a federally-established "nexus" threshold for state (and local) "business activity taxes" (BATs). State taxes on corporate profits are the most widely-levied state business activity taxes.[2] The term also encompasses such broad-based business taxes as the Michigan Single Business Tax (a form of value-added tax) and the Washington Business and Occupations Tax (a state tax on a business' gross sales).[3] The "nexus" threshold is the minimum amount of activity a business must have in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State laws imposing a tax on a business will set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must pay the tax. Federal statutes and federal and state court decisions can invalidate state nexus laws, however.

Proponents of H.R. 1956 claim that the bill would impose a "bright-line," physical presence requirement for BAT nexus.[4] This claim implies that if a corporation has a physical presence in a state, it could be subjected to a BAT by that state. In reality, the bill would create a plethora of exceptions to a physical presence standard. Many types of clear and substantial physical presence in a state that establish nexus for a business under current state and federal law would no longer be sufficient to obligate the business to pay a BAT to the state. For example, a corporation would no longer have nexus in a state under H.R. 1956 even if it had dozens of employees in the state negotiating purchases of supplies for the business or a million dollars worth of materials in the state being assembled into finished goods by another business. There is no question that such substantial physical presence in a state would establish BAT nexus for the corporation under current law.

In 1959, Congress enacted a BAT nexus threshold that was intended to be temporary (but was never repealed) and that covered just two limited categories of in-state business activity. Public Law 86-272 bars a state from taxing the profits of an out-of-state corporation selling physical products if the business' activities within the state are limited to soliciting orders for those products (using the mail, telephones, the Internet, or traveling salespeople) and delivering them into the state from an out-of-state origination point. H.R. 1956 would vastly expand the reach of P.L. 86-272 by

- extending it to the entire service sector of the economy; and
- extending it from income taxes to all business activity taxes; and
- establishing numerous new "safe harbors" from nexus (while retaining the safe harbors for in-state solicitation and delivery). For example, under H.R. 1956 a corporation could have an unlimited number of employees or an unlimited amount of equipment or other property in a state for up to (and including) 21 days per year without establishing BAT nexus.

(The Appendix to this report contains a more detailed discussion of the provisions of H.R. 1956 and the specific types of corporations and business activities it would exempt from state and local business activity taxes. The Appendix is available at www.cbpp.org/ 9-14-04sfp-append.pdf.)

Adverse Impacts of H.R. 1956 on State Finances and Corporate Tax Fairness

Replacing existing nexus laws with the nexus threshold contained in H.R. 1956 would have a number of serious adverse consequences for state finances and tax fairness:

- *Substantial loss of state corporate tax revenue in the aggregate.* H.R. 1956 would cause a large majority of states to lose substantial corporate profits tax payments (and other BAT payments as well) from out-of-state corporations that would no longer be subject to tax because of the higher nexus threshold that would be established by the bill. The untaxed profits frequently would not be taxed by the state(s) in which the corporations remained taxable, either, leading to a substantial net loss of corporate tax revenue for states in the aggregate.

  - *Example.* A Maryland-based industrial equipment manufacturer takes its orders over the Internet but has nexus in every state in which it has customers because its employees install that equipment at its customers' place of business. Under H.R. 1956 this manufacturer now could easily arrange to have corporate income tax nexus only in Maryland. The bill provides that the use of an agent in a state does not create nexus so long as the agent has more than one client. The clients may be related to the agent through common ownership. The manufacturer could bring itself under this safe harbor by forming one subsidiary to employ the equipment installers and two others to manufacture the equipment (say, one subsidiary to manufacture Product A and another to manufacture Product B). Such a restructuring would make the installation subsidiary the agent of two legally-distinct manufacturer "clients." This would satisfy the terms of the "safe harbor" in H.R. 1956 and block all states except Maryland from taxing the corporation's profit from equipment sales. Because of how Maryland taxes the profits of multistate corporations, none of the corporation's profit earned on equipment sales made to non-Maryland customers would be taxable in Maryland, either — meaning that this corporation's total tax payments to the states taken together likely would drop precipitously.[5] Multiply this scenario by thousands of businesses in scores of states, and it becomes clear that the aggregate loss of state corporate income tax revenue would be substantial.

  (The states are currently being surveyed to obtain their estimates of the loss of revenue that would result from the enactment of H.R. 1956. The California Franchise Tax Board has already estimated that if the provisions of H.R. 1956 were enacted into *state* law, the state would be losing more than $500 million in revenue annually within five years.[6])

- *Individual states deprived of their fair share of tax revenue.* Regardless of whether H.R. 1956 enabled a particular corporation to pay less business activity tax in total, the bill would deprive individual states of their fair share of taxes from out-of-state corporations earning profits within their borders and benefiting directly from public services they provide.

  - *Example.* A Massachusetts bank makes home mortgage loans to Connecticut borrowers who apply for the loans over the Internet or during an in-home visit by an independent mortgage broker engaged by the bank. The borrowers go to settlement at a Connecticut title company of their choice. H.R. 1956 would block Connecticut from taxing the bank's profits on those loans: the bank has no employees and owns no property in Connecticut, and its use of Connecticut brokers and settlement agents does not create nexus because the companies provide these services to multiple banks. Connecticut is barred from taxing any of the bank's profits on Connecticut home loans despite the fact that the value of the homes that serve as mandatory collateral for the loans is crucially dependent on the quality of local schools, parks, roads, and police and fire protection provided by Connecticut and its local governments. Under provisions of Massachusetts' bank taxation law, Connecticut's inability to tax the bank likely would result in the bank's paying tax on profits from the Connecticut loans to Massachusetts instead.[7] Nonetheless, H.R. 1956 would deny Connecticut its fair share of tax on profits earned within its borders by a corporation that is benefiting from public services Connecticut provides to the bank's collateral and its in-state settlement agents.

- *Hamstringing state efforts to stop abusive tax sheltering.* H.R. 1956 would block states from asserting corporate income tax nexus over out-of-state companies that license trademarks to related in-state businesses. This would deprive states of a key tool they are using to shut down perhaps the most abusive state corporate tax shelter in widespread use.

  - *Example.* Under a tax shelter employing a so-called "intangible holding company" (IHC), a corporation operating retail stores like The Limited transfers its trademarks to a subsidiary corporation it has created in a tax-haven state like Delaware or Nevada. The stores then pay royalties to this subsidiary for the use of the trademarks. These royalties are tax-deductible (as a cost of doing business) and hence can be used to largely or entirely eliminate corporate income tax liability in the states in which the corporation is actually doing business and earning its profits.[8] Meanwhile, the royalty payments are not taxed by the tax-haven state. More than half the states with corporate income taxes seek to nullify this tax shelter by asserting that the IHC is directly taxable in any state from which it receives royalties.[9] H.R. 1956 would close off this avenue of attack on IHCs by providing that the presence in a state of an intangible asset like a trademark does not create BAT nexus for the out-of-state corporation that owns it. In so doing, H.R. 1956

would reverse court decisions in Maryland, New Mexico, North Carolina, and South Carolina that held that IHCs had nexus in those states, as well as repeal the nexus policy of some 20 additional states.[10]

(While states can amend their tax laws to implement alternative approaches to nullifying the IHC tax shelter, multistate corporations have successfully blocked such laws in a majority of states in which their enactment has been sought.[11] In contrast, many states can assert nexus over the out-of-state owner of the trademark under their existing BAT nexus laws — laws which H.R. 1956 would invalidate.)

- *Opening up vast new tax-avoidance opportunities.* H.R. 1956 would open up enormous new opportunities for corporations to shelter their profits from taxation in states in which the profits are earned by dividing themselves into separate legal entities (such as a parent corporation and several subsidiary corporations). For example, the bill provides that a corporation can send an unlimited number of employees and an unlimited amount of equipment into a state without establishing BAT nexus so long as the employees and equipment are not in the state for more than 21 days in a calendar year. However, this 21-day limit — like all the "safe harbors" from nexus in H.R. 1956 — applies separately to every individual corporation in a multi-corporate group.

  - *Example.* A business providing on-site computer repair and troubleshooting services needs to have employees constantly in a neighboring state because it has numerous customers there. However, it would like to avoid triggering BAT nexus in the neighboring state because the corporate tax rate in its home state is lower. The company could achieve both objectives with modest legal and accounting costs by incorporating 18 different subsidiaries to employ its repairmen and rotating responsibility for providing service in the neighboring state among those subsidiaries at 21 day intervals. If the company were too small to employ 18 repairmen, it could rotate their employment among the subsidiaries as well.[12]

(See the Appendix for an explanation of why this is an entirely plausible scenario and more examples of the kinds of tax-avoidance opportunities that H.R. 1956 would open up.)

In a recent report, the Congressional Research Service concurred that the enactment of federal BAT nexus legislation like H.R. 1956 would have an adverse impact on state tax structures:

> [Such legislation] would have exacerbated the underlying inefficiencies [arising from the non-uniformity among the states in certain state corporate tax rules] because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have

expanded the opportunities for tax planning and thus tax avoidance and possibly evasion.[13]

Adverse Impacts of H.R. 1956 on the Economy

Enactment of H.R. 1956 also would adversely affect the economy.

- *Degraded public services.* By depriving states of business activity tax revenues they currently are collecting, the legislation could further impair their ability to provide services that are a critical foundation of a healthy national economy — such as high-quality K-12 and university education and transportation infrastructure.

- *Costly litigation.* The U.S. Supreme Court's 1992 *Quill* decision reaffirmed a 1967 decision that established "physical presence" as the nexus threshold for state *sales* taxes.[14] Far from being the "bright line" nexus standard sought by the Court, litigation on the meaning of "physical presence" has continued unabated since *Quill*.[15] H.R. 1956 not only would re-create these conflicts in the BAT arena, but it would also create new areas of litigation because it contains numerous ambiguous definitions whose meaning could only be resolved by courts. Given the substantial new limitations placed on their revenue-raising ability by H.R. 1956, states and localities would have no choice but to engage in widespread litigation aimed at establishing the narrowest-possible interpretation of the nexus "safe harbors" contained in the law. Such litigation would waste the limited financial and human resources of taxpayers and tax administrators alike.

  - *Example.* H.R. 1956 states that having employees conduct the following activities in a state does not create nexus there for the corporation employing them: "activities in connection with a possible purchase of goods or services for the business," "gathering news and covering events for . . . distribution through the media," and "participation in educational or training conferences. . . ." H.R. 1956 also says that leasing or owning property "to the extent used ancillary to" these three activities also is not nexus-creating. This implies that corporations could lease or own facilities dedicated to these activities in a state — procurement offices, news bureaus, and training centers, respectively — without creating nexus. "Ancillary" is not defined in H.R. 1956. The same term was interpreted in a 1992 U.S. Supreme Court decision that found that ownership of a sales office was not "ancillary" to the in-state "solicitation" activities protected by Public Law 86-272; however, P.L. 86-272 does not include an express "safe harbor" for property ownership, as H.R. 1956 does. Thus, considerable litigation can be anticipated regarding whether H.R. 1956 creates a nexus "safe harbor" for company-owned (or rented) procurement offices, news bureaus, and training centers.[16]

- *Economically sub-optimal business location decisions.* A physical presence nexus threshold may interfere with the efficient allocation of economic resources by creating an artificial disincentive for the placement of facilities in states where fundamental economic considerations might otherwise dictate they should be located. As the Director of the Oregon Department of Revenue has argued:

  > [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[17]

  - *Example.* Jeff Bezos, the CEO of Amazon.com, has acknowledged that he would have preferred to establish his company in California rather than Washington but did not do so in order to avoid having to charge sales tax to the large customer market located in California.[18] Had Amazon.com been obligated to charge sales tax to California customers regardless of whether it was physically present in that state, Bezos would not have had an incentive to establish the company in a less-than-ideal location. A physical presence nexus threshold for BATs could create the analogous incentive for economically sub-optimal location decisions.

- *Artificial competitive advantage for the most aggressive tax-avoiders.* Enactment of H.R. 1956 would result in significant differences among corporations in the effective rate at which their profits are taxed —tilting the playing field to the competitive advantage of some corporations and the disadvantage of others. H.R. 1956 would reward with the lowest state corporate tax liability those corporations willing to implement the most aggressive corporate restructuring and tax-avoidance strategies — such as the intangible holding company and "18 subsidiaries" tax shelters discussed above. Large corporations with multistate operations would have much greater expertise, resources, and opportunities to implement these strategies than would small, family-owned corporations serving a local market.

  - *Example.* A multistate bookstore chain places computer kiosks in all its stores. The kiosks are linked to its World Wide Web operation. Store employees help customers place orders for books not available in the store at the kiosks. The stores advertise the address of the Web site in all their advertising. The stores even accept returns of unwanted books purchased at the Web site. Despite this critical sales assistance provided by the stores to

the online operation, under H.R. 1956 the Web operation could easily avoid having to pay tax on its profit to any state(s) except the one(s) where it has offices, warehouses, or similar facilities.[19] The owner of a local independent bookstore, on the other hand, lacking the resources to set up an out-of-state electronic commerce Web site and distribution facility, would have 100 percent of his profit subject to taxation by the state in which the store is located.

A "Physical Presence" Nexus Standard Out of Sync with a 21st Century Economy

We live at a time when the combination of the Internet, inexpensive interstate transportation, and widely available business and consumer credit often enables even the smallest of businesses to tap into the market of distant states far more successfully, efficiently, and profitably than a horde of traveling salespeople could hope to do. In light of the vast expansion of interstate sales that has been sparked by the recent development of "electronic commerce," there seems to be a growing realization among many members of Congress that the "physical presence" nexus threshold for the imposition of state *sales* taxes established by the U.S. Supreme Court's 1992 *Quill* decision makes little sense. In fact, in 2001 more than 40 members of the Senate strongly signaled that they supported overturning *Quill*, repealing its physical presence nexus requirement, and substituting a nexus threshold that would allow a state to impose a sales tax payment obligation for sales to state residents on any corporation with more than $5 million in annual sales — regardless of whether the corporation was physically present within the borders of its customers' states.[20] It seems likely that even more members will vote this way if — as expected — such legislation is taken up during this Congress.

In light of these developments, it is ironic that the supporters of H.R. 1956 are proposing now to permanently enshrine substantial in-state "physical presence" as the threshold for the imposition of state business activity taxes. It is even more ironic that they characterize this as a "modernization" of P.L. 86-272. Given the numerous organizational strategies and technologies corporations can now employ to make substantial sales and earn substantial profits in a state without actually being physically present within its borders, it is clear that a physical presence nexus threshold is obsolete and unfair. Can it really be argued seriously that states should be barred from taxing the profits of a corporation like Dunkin' Donuts because it chooses to franchise its ubiquitous restaurants rather than own them directly? That is the kind of step backward in tax policy that H.R. 1956 would implement.

H.R. 1956: An Internally Inconsistent Nexus Policy Designed to Favor Particular Corporations

Proponents of federal BAT nexus legislation have stated time and again that the fundamental principle underlying the bill is that corporations do not benefit from public services in states in which they do not have a physical presence and therefore should not be required to pay a BAT to such a state.[21] Even assuming for the sake of argument that this indefensible principle were valid, it is clear that the bill as actually drafted does not reflect it — nor any other

rational balancing of benefits received by businesses from public services and the businesses' obligation to support those services through the payment of taxes.

A principle that says that businesses should not be subject to tax in a state in which they lack a physical presence because they obtain no benefits from government services cannot be squared with a bill that allows corporations to have massive — indeed unlimited — amounts of several categories of employees, property, representatives, and independent agents present within a state without establishing BAT nexus. Nor can the principle be squared with a bill that bars a state from imposing an income tax on a corporation that has 100 people in the state for 21 days in a particular year but allows the state to tax a business that has only a single employee in the state for 22 days. Clearly, the former business is likely to be benefiting more from state-provided services than is the latter. Nor can any rational balancing of public service benefits and tax payment obligations be perceived in provisions of H.R. 1956 that allow the imposition of a BAT on a corporation that sends an employee into a state for a single day to paint houses but immunizes from taxation a corporation that sends an employee into the state for 20 days to repair computers. Again, it is clear in this example that the tax-exempt business is receiving more benefits from the state's public services than is the taxable business.

Contrary to the claim of its proponents, what is on display in H.R. 1956 is not implementation of the principle that no physical presence equals no benefits from public services equals no obligation to pay taxes to support those services. Rather, H.R. 1956 is simply a "grab bag" of nexus "safe harbors" that the corporations lobbying for it would benefit from and think they may have sufficient clout to get through Congress. The Coalition for Rational and Fair Taxation (CRAFT) that was formed to push the bill in previous sessions of Congress has not publicly disclosed its membership for several years, but it is easy to discern the motives of some previously-identified member corporations.[22]

- CBS and ABC would benefit from the expansion of P.L. 86-272 to encompass service businesses, since this would insure that in-state solicitation of advertising contracts from major corporations would not establish BAT nexus for the two networks. They would also benefit from the safe harbor permitting employees to be present in a state gathering news and covering events without establishing nexus.

- A corporation like Cisco Systems would likely benefit from a new safe harbor from nexus for any activities conducted in a state for up to 21 days by its employees or for an unlimited amount of time by one of its own subsidiaries.[23] Presumably the Internet routers and other networking equipment sold by Cisco are complex devices that sometimes require on-site installation or trouble-shooting assistance from Cisco employees — a post-sale activity not currently protected by P.L. 86-272.

- H.R. 1956 would benefit a corporation like The Limited, which has been sued by multiple states claiming that its Delaware trademark holding companies had nexus in those states. As explained above, H.R. 1956 would put an end to such litigation in the future and hinder state efforts to shut down this tax shelter.

The pursuit of self-interest by these kinds of companies is not synonymous with a rational nexus threshold, however. A congressionally-imposed BAT nexus threshold even loosely based on the current text of H.R. 1956 would be a prescription for further litigation, inequity among businesses, and erosion of a vital source of funding for state and local services.

Truly "Rational and Fair" Alternatives to H.R. 1956 Are Available

Congress may eventually conclude that enacting a uniform nexus standard for the imposition of state business activity taxes would be an appropriate exercise of its authority to regulate interstate commerce. It would be well advised not to take such action without careful study, however, given the potentially enormous impact on state tax revenues and the relative tax burdens of different kinds of businesses. Nor should Congress develop a new nexus law without first encouraging state and local government and business representatives to try to negotiate a compromise approach to defining BAT nexus on their own.

If Congress does decide to act again in this area, however, workable and fair alternatives to H.R. 1956 are available. A proposed nexus standard developed by the Multistate Tax Commission, for example, would base the creation of nexus on relatively objective measures of the dollar amount of a business' sales occurring in a state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.[24] Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a BAT on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

A nexus threshold based on the volume of sales in a state can achieve this balancing of tax compliance costs and tax liability in a direct, administrable manner. Reasonable people can disagree about what the threshold should be. If business and state and local government representatives are unable to agree, Congress can be the final arbiter — just as Congress would be in proposed legislation establishing a sales-based nexus threshold for sales taxation. H.R. 3184, the Istook-Delahunt "Streamlined Sales Tax" bill introduced in the 108th Congress, would have empowered any state adopting a prescribed set of measures aimed at simplifying its sales tax to require a non-physically present retailer to collect the state's sales tax if the seller had more than $5 million in nationwide sales.

Qualitative nexus thresholds that look to the type of activities occurring in the state and/or the relationships between in-state and out-of-state entities inherently create irrational and conflict-ridden tax policy. Public Law 86-272 itself demonstrates this. A corporation earning millions of dollars of profit in a state in which scores of its employees are continuously soliciting sales and dozens of its vehicles are continuously plying the roads loaded with millions of dollars worth of goods does not have income tax nexus under P.L. 86-272. At the same time, a small out-of-state retailer who sends employees into the state just twice each month to assemble a swing-set in someone's back yard for a few hundred dollars in profit *can* be required to pay an

income tax to the state. Such disparate results cannot possibly be characterized as "rational and fair taxation."

Within a year or two, Congress may formally acknowledge that "physical presence" no longer makes sense as the nexus threshold for state sales taxes by enacting legislation along the lines of the Istook-Delahunt bill. It is almost inconceivable that this occasion might coincide with the elevation of an inconsistent and arbitrary "physical presence" threshold like that embodied in H.R. 1956 to the supreme law of the land.[25] If Congress is determined to act in this area, a better approach would be to repeal P.L. 86-272 and substitute a nexus threshold based entirely on objective, quantitative measures of in-state business presence and activities. The $5 million sales threshold in the Istook-Delahunt bill itself or the Multistate Tax Commission's "factor presence" nexus standard (which looks to the dollar amount of property, payroll, or sales located in a state) would be good starting points for congressional consideration.

Notes

[1] See: Multistate Tax Commission, *Federalism at Risk*, June 2003, Appendix D: Factor Presence Nexus Standard. Available at http://www.mtc.gov/Federalism/FedatRisk--FINALREPORT.pdf.

[2] Corporate income taxes are levied by 45 states, the District of Columbia, and New York City. In 2002 these taxes supplied $28 billion to state and local treasuries.

[3] In 1998 these other business activity taxes raised at least $12 billion for state and local governments. The $12 billion figure is an estimate of the business activity taxes other than corporate income taxes that are potentially affected by the BAT nexus legislation. The estimate was prepared by the Council on State Taxation, one of the business organizations supporting enactment of federal BAT nexus legislation. (See: letter from COST to members of the U.S. House of Representatives in support of H.R. 2526, July 16, 2002. H.R. 2526 was the version of the BAT nexus legislation introduced in the 107th Congress.) This is a somewhat conservative estimate because COST does not agree that gross receipts taxes frequently imposed on insurance companies, telecommunications companies, and other utilities fall within the definition of BATs contained in the bill — a dubious interpretation.

[4] "The bill would establish a PHYSICAL PRESENCE test, such that a State could only tax an out-of-state business if the out-of-state business has a physical presence in the taxing state." *Summary Explanation of the Business Activity Tax Simplification Act* on the Web site of Representative Bob Goodlatte. Available at www.house.gov/goodlatte/batsummary.htm. Capitalization in the original.

[5] Like approximately 8 states, Maryland taxes the profits of multistate manufacturers only in proportion to their sales to Maryland customers. Accordingly, a Maryland-based manufacturer with no customers in Maryland would pay no corporate income tax to the state. Moreover, like roughly half the states, Maryland has not enacted a "throwback rule" to subject to taxation the profits earned by a Maryland manufacturer in other states in which the manufacturer has not established nexus. As a result of the combination of these two corporate income tax "apportionment" policies, the lion's share of the nationwide profit of a Maryland manufacturer that was protected from taxation in other states by H.R. 1956 would be "nowhere income" — profit that would not be taxed by any state. The interaction between H.R. 1956 and rules like those of Maryland that base corporate income tax liability on in-state sales alone are discussed in a separate Center report. See: Michael Mazerov, *Federal "Business Activity Tax Nexus" Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes,* Center on Budget and Policy Priorities, revised May 9, 2005.

[6] FTB Staff Analysis of A.B. 2061. See also: Staff of the California Franchise Tax Board, "California FTB Analyzes Business Activity Tax Proposal in H.R. 3220," *State Tax Notes*, May 31, 2004. The FTB analysis was based on H.R. 3220, the version of the BAT nexus legislation introduced in the 108th Congress. H.R. 3220 and H.R. 1956 are virtually identical.

[7] Like approximately a dozen states, Massachusetts has enacted a special corporate income tax apportionment law for financial institutions that provides for the "throwback" of non-Massachusetts receipts to Massachusetts when a bank headquartered in the state is not taxable in the state in which its customers are located. See Chapter 63 of the Massachusetts statutes.

[8] An article written several years ago by an investigative reporter revealed just how little economic substance many of these "Delaware Holding Companies" have:

> "For a glimpse into this quiet and lucrative world, head up to the 13th floor of 1105 N. Market St.. Through smoked-glass windows, a visitor can view the high-rise headquarters surrounding Wilmington's prestigious Rodney Square: DuPont and Hercules, Wilmington Trust and MBNA. But turn back, and look inside this slender office tower. Tucked within the building's stark, upper floors, is another, hidden corporate center. Here, more than 700 corporate headquarters make up a vast and quiet business district of their own. The lobby computer lists their names: Shell and Seagram and Sumitomo, Colgate-Palmolive and Columbia Hospitals and Comcast, British Airways and Ikea, Pepsico and Nabisco, General Electric and the Hard Rock Cafe. How do 700 corporate headquarters squeeze into five narrow floors? How do 500 fit

> on the 13th floor alone? "Frankly, it's none of your business," said Sonja Allen, part of the staff that runs this corporate center for Wilmington Trust Corp. . . ." "Some of my clients are saving over $1 million a month, and all they've done is bought the Delaware address," said Nancy Descano, holding company chief of CSC Networks outside Wilmington."

Joseph N. DiStefano, "In the War Between the States, Delaware is Stealing the Spoils." Gannett News Service, January 25, 1996.

[9] John C. Healy and Michael S. Schadewald, 2004 *Multistate Corporate Tax Guide*, "Activities Creating Franchise or Income Tax Nexus (Part 1)," Aspen Publishers (CD-ROM).

[10] The Maryland case upheld the state's authority to require the intangible holding company of the Syms clothing chain to pay Maryland corporate income tax on the royalties it earned by licensing use of the Syms trademark to Maryland Syms stores. The analogous New Mexico, North Carolina, and South Carolina cases involved Kmart, The Limited, and Toys R Us, respectively.

[11] Bills denying an income tax deduction for royalty payments to IHCs were introduced in 2003-2005 in 15 states: Arkansas, the District of Columbia, Georgia, Indiana, Kentucky, Maryland, Massachusetts, Missouri, New York, Pennsylvania, Rhode Island, Tennessee, Texas, Virginia, and Wisconsin. After intense business lobbying, the enacted Arkansas, D.C., Georgia, Kentucky, and Virginia bills were watered down to the point that they arguably will be largely ineffectual against IHCs. Only Maryland, Massachusetts, and New York enacted strong anti-IHC statutes in 2003-5. (Seven other states have previously enacted royalty deduction disallowance statutes.) Bills to implement the other major anti-IHC mechanism, "combined reporting," were introduced in 2003-2005 in 12 states: Arkansas, Connecticut, Florida, Iowa, Kentucky, Maryland, Massachusetts, Missouri, New Mexico, Pennsylvania, Wisconsin, and Vermont. Only in Vermont was the legislation enacted. In short, despite the serious fiscal problems of the states in the past several years, the business community has had an excellent track record in blocking the two approaches to shutting down the IHC tax shelter that require state legislative action.

[12] See Note 48 for a description of another mechanism that would enable the business in this example to avoid nexus in all the states in which its customers are located.

[13] Steven Maguire, *State Corporate Income Taxes: A Description and Analysis*, Congressional Research Service, updated March 9, 2005.

[14] The holding in *Quill* reaffirmed the physical presence requirement for sales tax collection established by the Court's 1967 *National Bellas Hess* decision. Technically, the tax at issue in both cases was a use tax, not a sales tax. See: Michael Mazerov and Iris J. Lav, *A Federal "Moratorium" on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households*, Center on Budget and Policy Priorities, May 1998, Appendix A. Available at www.cbpp.org/512webtax.pdf.

[15] The U.S. Supreme Court's stated goal in its 1992 *Quill* decision was to establish a "bright line" physical presence nexus threshold for state imposition of *sales* taxes. Surveying the widespread sales tax nexus litigation that has occurred subsequent to *Quill*, a leading expert on Internet tax-related issues has stated flatly: "The current physical-presence standard for sales and use tax nexus has not created a bright-line test but instead has resulted in jurisdictional rules that are frequently ambiguous and inconsistent." (Karl Frieden, *Cybertaxation* (Arthur Anderson/CCH, Inc.), 2000, p. 356.) A leading law firm that litigates nexus cases for corporations concurs: "While . . . [*Quill*'s] 'bright line' [physical presence] rule was intended to bring clarity to the boundaries of legitimate state authority to impose an obligation to collect sales and use taxes, and to 'encourage settled expectations,' it has not produced the hoped-for certainty." (Troy M. Van Dongen, "Internet Retailers Under Fire: *Borders Online* Exemplifies the Predicament." Online newsletter of the Morrison & Foerster law firm, July 2002, available at www.mofo.com.)

[16] See Note 53.

[17] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation,

March 14, 2001.

[18] In a 1996 interview in *Fast Company* magazine, Bezos was asked: "You moved from New York to Seattle to start this business. Why?" He replied:

> It sounds counterintuitive, but physical location is very important for the success of a virtual business. We could have started Amazon.com anywhere. We chose Seattle because it met a rigorous set of criteria. It had to be a place with lots of technical talent. It had to be near a place with large numbers of books. It had to be a nice place to live — great people won't work in places they don't want to live. Finally, it had to be in a small state. In the mail-order business, you have to charge sales tax to customers who live in any state where you have a business presence. It made no sense for us to be in California or New York.
>
> Obviously Seattle has a great programming culture. And it's close to Roseburg, Oregon, which has one of the biggest book warehouses in the world. We thought about the Bay Area, which is the single best source for technical talent. But it didn't pass the small-state test. I even investigated whether we could set up Amazon.com on an Indian reservation near San Francisco. This way we could have access to talent without all the tax consequences. Unfortunately, the government thought of that first.

William C. Taylor, "Who's Writing the Book on Web Business," *Fast Company*, October/November 1996.

[19] H.R. 1956 provides that "using the services of another person, except [i.e., not including] an employee, in [a] State, on more than 21 days to establish or maintain the market in the State" creates nexus for the out-of-state business using the in-state person, "unless such other [in-state] person performs similar functions on behalf of at least one additional business entity during the taxable year." There is nothing in the legislation that requires that "one additional business entity" to be an independent third party. The Web-based bookselling operation could easily bring itself under this safe harbor by incorporating two nominally-distinct subsidiaries, for example, one selling hardback books and another selling paperbacks. Because the store personnel (who are not employees of the Web site) would be helping "to establish or maintain the market" for two "entities" — the subsidiary that sells hardback books and the subsidiary selling paperbacks — nexus would not be created for the Web operation by the activity of the stores' employees. (Other provisions of H.R. 1956 ensure that the use of the in-store kiosks themselves also would not create nexus for the Web operation.) As long as customers of the Web operation are nominally buying hardback and paperback books from two different companies, the Web operation can avoid creating nexus in the states where the retail stores are located. The two Web stores could easily contract to share the same Web site and warehouses; no change in physical operations would be necessary.

[20] As part of the consideration of legislation renewing the Internet Tax Freedom Act, Senator Mike Enzi offered an amendment providing for expedited congressional consideration of a resolution approving an interstate compact simplifying and standardizing state sales tax laws and authorizing states that had adopted the compact to require non-physically-present sellers to collect and remit sales taxes. Forty-three Senators voted against the motion to table the Enzi amendment. See: *Congressional Record*, November 15, 2001, pp. S. 11906-14.

[21] "The underlying principle of this legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, 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. By imposing a physical presence standard for business activity taxes, H.R. 3220 ensures that state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state." Testimony of Arthur R. Rosen in support of H.R. 3220, Subcommittee on Commercial and Administrative Law, House Judiciary Committee, May 13, 2004. Again, H.R. 3220 was the version of BAT nexus legislation introduced in the 108th Congress and was virtually identical to H.R. 1956.

[22] The last publicly-available listing of CRAFT's membership (2001) named as members American Express, Cisco Systems, Kodak, J. Crew, Landmark Communications, The Limited, Metromedia Restaurant Corp, Microsoft, Sara Lee, Sony, Viacom/CBS, and Walt Disney/ABC, as well as "Six other corporations (in the publishing, Internet, and retailing fields), each with annual gross revenues of between $1.5 billion to $10 billion."

[23] Recall again that a corporation can use a subsidiary to conduct activities on its behalf in another state for an unlimited number of days in a year without thereby establishing nexus so long as the subsidiary works for at least two other related entities. See Notes 19 and 48.

[24] See the source cited in Note 1.

[25] While H.R. 1956 has been introduced as a free-standing bill, many observers believe that its best chance for enactment would be as an amendment to legislation that would reverse the *Quill* decision and empower states adopting the so-called "Streamlined Sales Tax Agreement" to require non-physically-present catalog and Internet merchants to collect and remit sales taxes. Three organizations representing major multistate corporations have been particularly active in seeking the enactment of federal BAT nexus legislation along the lines of H.R. 1956, but they differ somewhat in their position with respect to the relationship between BAT legislation and legislation reversing *Quill*.

As noted above, a "Coalition for Rational and Fair Taxation" has been organized with the apparent sole purpose of lobbying for BAT nexus legislation, and it clearly and strongly supports the enactment of H.R. 1956 as a free-standing bill. CRAFT does not appear to have articulated a position on whether states adopting the Streamlined Agreement should be empowered to require non-physically-present merchants to collect and remit sales taxes.

The Council on State Taxation represents over 500 major multistate corporations on state tax policy matters. COST has adopted a formal policy statement taking the position that enactment of a "physical presence" BAT nexus standard is a *quid pro quo* for expanded state authority to require non-physically-present merchants to collect and remit sales taxes (and vice-versa). COST has also adopted a second statement on what such BAT nexus legislation should contain. A spokesperson for COST wrote that H.R. 3220 (the predecessor to H.R. 1956) satisfied all the requirements for BAT nexus legislation set forth in the policy statement, meaning that COST supported the enactment of H.R. 3220 in conjunction with legislation empowering states to impose their sales taxes on remote sales. See: Stephen Kranz, "COST Supports Federal Legislation with Carrot-and-BAT Approach," *State Tax Notes*, October 20, 2003. "Alone, H.R. 3220 meets the 'musts' and 'shoulds' of the COST Policy Statement on business activity tax nexus and has our support in that regard." Again, H.R. 1956 is virtually identical to H.R. 3220.

The Business Roundtable represents approximately 150 major multistate and multinational corporations. Like COST, the Business Roundtable has adopted a formal policy position that enactment of a "physical presence" BAT nexus standard is a *quid pro quo* for expanded state authority to require non-physically-present merchants to collect and remit sales taxes. The Roundtable also endorsed the enactment of H.R. 3220 as a free-standing bill.

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PROPOSED "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION WOULD SERIOUSLY UNDERMINE STATE TAXES ON CORPORATE PROFITS AND HARM THE ECONOMY

By Michael Mazerov

Appendix:

What Would H.R. 1956 Actually Do? What Kind of Tax-avoidance Opportunities Would Its Enactment Open Up?

The "nexus" threshold is the minimum amount of activity a business must have in a particular state to be subject to taxation in that state. Nexus thresholds are established in the first instance by state law; state laws imposing the corporate income tax and similar "business activity taxes" (BATs) define the nature or level of activity conducted in the state that obligates a business to pay the tax. However, the Commerce Clause of the U.S. Constitution grants Congress the authority to preempt these laws.

In lobbying for the enactment of H.R. 1956, organizations representing major multistate corporations purport to be seeking federal legislation that would invalidate any portion of a state's existing nexus law that imposes a BAT on a business with less than a "physical presence" within the state. The bill provides that "No taxing authority of a State shall have power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person's activities in interstate commerce unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed."[26] The claim that business seeks no more than a "physical presence" BAT nexus threshold is highly misleading however, because H.R. 1956 goes on to create numerous nexus "safe harbors" — types of clear and substantial physical presence a business could have in a state that nonetheless would be deemed insufficient to obligate the business to pay a BAT.

Extending Federal Public Law 86-272 to the Service Sector and to Non-Income Based Taxes

One of the new nexus safe harbors that would be enacted in H.R. 1956 is an expansion of an existing federal law, Public Law 86-272. P.L. 86-272 was enacted in 1959 and intended to be a temporary moratorium on the ability of states to impose corporate profits taxes on certain out-of-state corporations; however, the law was never repealed.[27] P.L. 86-272 decrees that a state may not impose a corporate profits tax on an out-of-state corporation if:

- the corporation's only activity within the state is *soliciting orders* for the sale of *physical goods*, and
- the orders are approved at an out-of-state office of the seller, and
- the goods are shipped into the purchaser's state from an out-of-state location.

P.L. 86-272 clearly represents a nexus safe harbor because it allows corporations to have an unlimited number of salespeople in a state at all times yet remain exempt from income tax if the salespeople work out of home offices or visit from out of state.[28] In the absence of Public Law 86-272, the regular presence of a salesperson in a state would be sufficient to obligate the corporation employing her to pay some income tax to that state (assuming that the corporation was profitable). P.L. 86-272 also allows a corporation to have an unlimited number of its own trucks plying the roads of a state loaded with an unlimited amount of company-owned goods en route to customers and yet still not be subject to corporate income tax in such a state. Finally, P.L. 86-272 permits companies to provide their sales forces with company-owned cars, product samples, computers, telephones, furniture, and similar equipment without thereby establishing corporate income tax nexus in the states where the salespeople solicit business.[29]

H.R. 1956 substantially expands the coverage of P.L. 86-272 along two dimensions. First, the bill extends P.L. 86-272 to protect from taxation corporations soliciting sales of both services and intangible property. If H.R. 1956 were enacted, for example:

- A Delaware bank could send an unlimited number of loan officers into Maryland to visit Maryland businesses and encourage them to borrow from the bank, yet incur no obligation to pay a tax to Maryland on the portion of the bank's profit attributable to its interest earnings on loans to Maryland borrowers.[30]
- A New York-based television network could send an unlimited number of advertising salespeople to visit major corporations headquartered in other states to solicit their purchases of air time without establishing BAT nexus in those states.
- A franchisor like Dunkin' Donuts could enter a state an unlimited number of times to solicit sales of its franchises (a form of intangible property) to potential franchisees, for example, by renting a meeting room in a hotel to conduct a sales meeting.

Second, H.R. 1956 extends the protections of P.L. 86-272 to taxes other than corporate income taxes. Such taxes would include the

- Washington state Business and Occupations Tax (a generalized tax on business gross receipts),
- Michigan Single Business Tax (a form of value-added tax),
- Delaware Merchants' and Manufacturers' License Taxes (gross receipts),

- New Hampshire Business Enterprise Tax (value-added), and
- Texas Franchise Tax (net worth component).

Blocking a State from Taxing Virtually Any Corporation that Does Not Need to Maintain a Permanent "Brick and Mortar" Facility within the State's Borders

In order to interact with their customers and/or produce their goods and services, many kinds of businesses find it necessary to send employees and/or equipment, materials, and inventory they own into states in which they do not actually maintain offices, stores, warehouses, factories, or other permanent facilities. Such interstate activity is particularly common where a major metropolitan area lies in a multistate region, such as the Maryland/DC/Virginia area or the New Jersey and Connecticut suburbs close to New York City.

The following are just a few examples of the myriad ways in which businesses conduct interstate commerce without establishing a permanent physical presence in another state:

- Television broadcasters and movie studios may enter states temporarily to shoot programs, make movies, or cover sporting events.
- Business equipment manufacturers and software companies may find it necessary to visit their customers' place of business to install, calibrate, maintain, and repair the products they sell and train customer personnel in how to use them.
- Construction companies and construction subcontractors may send skilled workers, heavy equipment, and temporary office trailers to a construction site of a commercial building, a highway project, or a residential development.
- In the course of designing a new corporate headquarters building for a client, an architecture firm may send architects to consult with executives of the client at the current headquarters, and then have the architects monitor the construction process.
- Advertising agency personnel may meet with a client at the client's place of business and enter a state temporarily to take photographs or film commercials.
- A record company may sponsor a concert tour of an artist under contract and lease the sound equipment and vehicles that move the artist and concert support personnel from city to city. Record company employees may enter a state temporarily to monitor the making of a new recording at a particular studio or mixing facility.

- A manufacturing corporation may transport partially-manufactured goods into another state for further processing or assembly by another company, while retaining ownership of such "work in process inventory."

- In order to get products into the hands of customers more quickly or inexpensively, an Internet merchant or an industrial parts supplier may store inventory it owns at a warehouse operated by Federal Express or another company in the so-called "logistics industry" and contract with that company to deliver the goods to purchasers on command.

A profit-making corporation that sent employees and/or property into a state to conduct any of these kinds of activities would almost certainly have sufficient physical presence within the state to be subject to that state's corporate income tax or other BAT if the state chose to impose it. That would be true even of a seller of services newly covered by H.R. 1956's expanded version of P.L. 86-272, since both performing services in a state and engaging in almost any kind of post-sales interaction with a customer are beyond P.L. 86-272's nexus safe harbor for "solicitation."

Under H.R. 1956, however, all of the corporations in these examples likely could arrange their affairs to avoid income tax liability to any state in which they did not maintain a permanent, "brick-and-mortar" facility — regardless of how often they sent employees and/or property into such a state. A number of provisions of H.R. 1956 would interact to provide protection from nexus for these kinds of activities and companies.

The 21-Day Physical Presence Safe Harbor

First, H.R. 1956 provides that "physical presence" sufficient to establish BAT nexus is not established by the in-state presence of property and/or employees for 21 or fewer days in a taxpayer's taxable year. This 21-day limit can easily be circumvented, as will be discussed below. Even taken at face value, however, it likely would immunize a large number of corporations from BAT nexus in a significant number of states where the current language of P.L. 86-272 would not.

Since P.L. 86-272 was enacted, states have had to initiate considerable litigation to counteract claims by corporations that numerous activities the corporations engage in within states are subsumed in protected "solicitation." Indeed, multistate corporations attempted to sweep so many activities into "solicitation" that the Multistate Tax Commission (a joint agency of state revenue departments) was compelled to develop a detailed list of typical cross-border business activities that the states considered not to be protected by P.L. 86-272 and to put corporations on notice that the states were prepared to litigate the issue. (Such "unprotected activities" include training of customer personnel in the use of the purchased product and picking up unwanted or damaged goods.)[31]

Now, however, the new 21 day safe harbor in H.R. 1956 would significantly broaden the number of corporations protected from taxation by P.L. 86-272; it would enable corporations to engage in *both* "solicitation" and other activities *not* protected by P.L. 86-272, so long as the two

activities did not require the seller's employees to be in the state for more than 21 days combined. If H.R. 1956 were enacted, for example,

- A book publisher whose titles are sold by a particular bookstore chain could visit the chain's headquarters and individual stores in each state six times per year to take orders. As a result of the new 21 day safe harbor, the publisher also could send employees into the states to oversee book signings at retail bookstores on an additional 15 days per year without becoming subject to the states' corporate income taxes.

- A fast-food franchisor could hold two meetings per year in a state to try to sell new franchises. The new 21 day physical presence safe harbor would also enable the franchisor to send employees into the state for an additional 19 days per year to inspect existing franchisees for quality-control purposes without becoming subject to the state's corporate income tax.

- A New York advertising agency could visit a potential corporate client in Connecticut for three days to "pitch" and negotiate a contract for development of an ad campaign. As a result of the new 21 day safe harbor, the agency now could also send an unlimited number of its employees into Connecticut for an additional 19 days within the same year to shoot the commercials, show them to the client, and engage in any other type of activities it wished to.

Circumventing the 21-Day Limit

In addition to enabling corporations protected by P.L. 86-272 to engage in additional "unprotected," post-sale activities in a state without triggering nexus, the 21 day physical presence safe harbor in H.R. 1956 effectively would allow many large corporations to have an *unlimited* amount of equipment and employees in a state at all times so long as the corporation did not maintain a permanent facility in the state. The key to this possibility is the fact that the 21 day physical presence "safe harbor" applies to each individual corporation as a legal entity, including corporations that are subsidiaries of other corporations.

- Take, for example, a company that maintains a pool of employees that travel to its customers' place of business to maintain and repair computers. Since a year may be divided into approximately 18 periods of 21 days each, this company could incorporate 18 subsidiaries to employ its repair personnel and rotate which subsidiary was assigned to handle repair requests in a particular state in each 21-day period. If no individual subsidiary sent employees into a particular state for more than 21 days in a given year, BAT nexus would not be created for any of the subsidiaries. In short, the business would be taxable in only its home state despite the more-or-less permanent presence of its employees in its customers' states.

- Of course, any company that needed to have an intermittent (as opposed to a continuous) physical presence in a state but wanted to avoid nexus there could do so using fewer than 18 subsidiaries. For example, a movie studio that needed to

shoot two different movies on location in a particular state for 15 days each in a particular year could separately incorporate the two productions; indeed, that would likely be done for non-tax reasons anyway. When the movies were completed, the subsidiaries would be liquidated or merged back into the parent.

Corporations Already Go to Great Lengths to Shelter Their Profits from Taxation

There is nothing far-fetched about the scenarios just described. If the potential tax savings from avoiding nexus in a particular state were sufficiently large, corporations would willingly incur the legal and accounting expenses entailed in implementing these strategies.[32] Corporations already go to great lengths to shelter their profits from state and federal taxation:

- Thousands of corporations have been willing to incur significant accounting and legal expenses to incorporate and operate "intangible holding company" subsidiaries. The North Carolina *Limited* case cited in the body of this report revealed that The Limited established nine separate Delaware subsidiaries to hold title to the trademarks of the various retail chains it owned.[33]

- Over 1,300 corporations, including Dell Computer and "Baby Bell" company SBC Communications, have completely restructured their Texas operations into limited partnerships in order to take advantage of a self-imposed nexus limitation on out-of-state corporate partners enacted by Texas more than ten years ago.[34]

- A number of states and the U.S. General Accounting Office have documented a widespread corporate practice of "SUTA dumping." This is a tax-avoidance strategy used by corporations that tend to have high employee turnover and therefore are subject to high state unemployment tax rates. In one common form of SUTA dumping, corporations form new subsidiaries and transfer their employees to these subsidiaries to take advantage of lower unemployment tax rates for which new corporations typically are eligible. GAO documented that this strategy has been widely marketed by certain accounting and consulting firms, which apparently believe that the practice is a legal technique for minimizing state unemployment taxes.[35] A more recent article reported that the major accounting firms Deloitte & Touche and Pricewaterhouse Coopers were among those involved in setting up such tax shelters, charging $300,000-$400,000 for their services.[36] Congress itself recognized "SUTA dumping" as an abusive tax shelter and recently enacted legislation that bans it.[37]

- Corporations routinely create subsidiaries whose in-state activities are limited to soliciting sales in order to isolate activities that require physical presence in a state from the portion of the corporation that can be immunized from taxation by P.L. 86-272.[38]

- Investigations into federal tax shelters have demonstrated that corporations will incur substantial out-of-pocket costs to shelter profits from taxes. For example, for tax benefits alone, major corporations have laid out hundreds of millions of

> dollars to buy life insurance policies on millions of employees and tracked the deaths of those individuals long after they have left the employ of the companies. Life insurance-related tax shelters have been so lucrative for corporations that they have continued to pursue them despite repeated congressional crackdowns.[39]

In short, the 21-day safe harbor for temporary physical presence in a state contained in H.R. 1956 would allow many sophisticated multistate corporations to avoid having a business activity tax liability to all states in which they had customers except those in which they were headquartered or had some other type of permanent physical facility.[40] Substantial numbers of employees and substantial amounts of equipment could be maintained in states by such companies on a continuously rotating basis without creating BAT nexus. Of course, this belies the proponents' fundamental rationale for the legislation:

> Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens — economic as well as administrative — only on businesses that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means if a business is not physically present in a jurisdiction, it is *therefore* not receiving *any* benefits or protections from the jurisdiction, and it should not be required to pay tax to that jurisdiction.[41]

Clearly, a corporation that continuously maintains personnel and property in a state is, at the very least, receiving substantial police and fire protection from that state — whether or not it maintains a "brick and mortar" facility there.

Blocking States from Asserting a Corporation Has "Attributional Nexus" in the State

In its 1987 *Tyler Pipe* decision, the U.S. Supreme Court held that a state had the right to impose a business activity tax on an out-of-state corporation that had contracted with an independent in-state business to conduct activities that were "significantly associated with the [out-of-state corporate] taxpayer's ability to establish and maintain a market in [the] state for [its] sales." In an earlier (sales tax) nexus case, the Court had recognized that to allow a corporation to avoid creating nexus in a state simply by using "independent contractors" rather than its own employees to solicit business on its behalf "would open the gates to a stampede of tax avoidance."[42]

When, under the authority of these decisions, states impose a tax on an out-of-state corporation based on in-state activities conducted on its behalf by another business, this is often referred to as "attributional nexus." If states did not have the authority to establish nexus over an out-of-state corporation on an "attributional" basis, corporations would have virtual free reign to avoid nexus in every state except the one in which they are headquartered. This is because it is possible for a corporation to carry out almost any business function by contracting with an individual, an unrelated business, or a subsidiary to perform the function rather than having it done by its own employees using its own property.

H.R. 1956 contains three new safe harbors against the creation of attributional nexus that would, as the Supreme Court recognized, facilitate massive tax avoidance by corporations — above and beyond that resulting from the bill's other provisions.

First, H.R. 1956 allows an in-state business to conduct *any* activity on behalf an out-of-state corporation in a state for 21 days per year without creating BAT nexus for the latter. Since *Tyler Pipe* clearly established that hiring a business in a state to engage in activities that help "establish and maintain a market" for the out-of-state company creates BAT nexus for the out-of-state company, and since no court decision suggests that such activities must be conducted for a minimum number of days, this provision of H.R. 1956 inherently creates a new nexus safe harbor.[43]

Agents Not Involved in Selling Don't Establish Nexus

Second, H.R. 1956 provides that the *only* activities that create nexus in a state for an out-of-state corporation when they are conducted within the state by another party acting on its behalf are those that "establish or maintain the market in that State." In other words, contracting with another party to conduct activities *not* related to selling or interacting with customers would *never* be nexus-creating if H.R. 1956 were enacted. While it is not entirely clear when non-customer-related activities performed by another party would create BAT nexus under current law, most experts likely would agree that if the contract made the second party the actual legal *agent* of the company contracting for its services, such a contract *would* be nexus-creating. Examples of such an "agency relationship" under current law include the following scenarios:

- A manufacturing corporation establishes a subsidiary whose function is to purchase on its behalf all the inputs into its manufacturing process.[44] The subsidiary recruits and hires employees, contracts for the corporation's health and workers' compensation insurance, and buys raw materials and equipment. The subsidiary has employees engaged in these activities in numerous states throughout the year. The subsidiary has the authority to hire the employees and to sign contracts binding the parent to purchase insurance, raw materials, and equipment under the negotiated terms of the contracts. Under this scenario, the presence of the purchasing subsidiary's employees in a state would likely be sufficient to create BAT nexus for the parent in such state.

- A California manufacturer hires a second, unrelated Oregon business to continuously perform quality control checks on its behalf at an Oregon plant run by a third company that assembles a key subcomponent of the California manufacturer's products. The Oregon quality-control business has the authority to sign-off that the subcomponents meet the necessary specifications of the California manufacturer and to stop shipment of the products if they do not. Under this scenario, the presence of the quality control business in Oregon would likely be sufficient to create BAT nexus there for the California manufacturer.

If H.R. 1956 were enacted, however, nexus would no longer be created for the out-of-state manufacturers under either of these scenarios, because the activities conducted by the purchasing subsidiary and quality-control subcontractor do not involve "establishing and maintaining the market" for *sales* by the *manufacturer*. In short, any purchasing-related activities (as opposed to selling-related activities) conducted in a state by a third party would no longer be nexus-creating under H.R. 1956 — even where the very same activities would be nexus-creating if conducted by the corporation's own employees.

The "Two Business Entities" Loophole

The third attributional nexus-related provision of H.R. 1956 is the most far-reaching one and the one likely to do the most damage to state and local BAT revenues. The bill decrees that a state may not subject an out-of-state corporation to a BAT on the basis of in-state activities conducted on its behalf by another business so long as the in-state business "performs similar functions on behalf of at least one additional business entity during the taxable year." This ban on the assertion of attributional nexus applies even to activities aimed at "establishing and maintaining the market in the State" for sales by the out-of-state company.

The enormous potential impact of this safe harbor arises from the fact that it applies even if all of the parties are related. It effectively enables corporations selling goods and services to have their own employees engage in *any* activities in a state that help to facilitate such sales without creating nexus for the selling corporation. All the corporation needs to do is organize itself into at least three legal entities: one corporation that employees the workers conducting the "market establishing and maintaining" activities in the state in which the corporation wishes to avoid nexus, and at least two out-of-state subsidiary corporations that are the nominal "sellers" of the goods or services to the customers. To satisfy the latter condition, the corporation could form two subsidiaries to sell two different groupings of its product lines. The following are examples of tax-avoidance or tax-minimization opportunities that would be created by this provision of H.R. 1956:

- To maximize its ability to make sales throughout the United States, a Texas-based manufacturer of personal and network server computers needs to have the capability both to provide on-site warranty repair service of the computers it sells and to set up "local area networks" of those computers for its customers. It wishes to have its own employees perform these functions both to maximize its control over the quality of the work and because it does not wish to share the profits from the networking services with independent subcontractors who could be hired to provide them. The corporation is especially anxious to avoid establishing BAT nexus outside of Texas because Texas' method of taxing the profits of multistate corporations ensures that none of the profit the corporation realizes on the actual sale of the computer equipment to non-Texas customers will be taxed in Texas if it is not taxed anywhere else.

  If H.R. 1956 were enacted, this corporation could easily ensure that the profit it realizes on the sale of the computer hardware itself would not be taxable outside Texas (and therefore anywhere). The corporation could reorganize itself into

three legal entities: one to employ the staff who provide on-site warranty repair and networking services, one to sell desktop computers, and one to sell server computers. The performance of the on-site repair and networking services in the customers' states, even if done by a subsidiary, would ordinarily establish BAT nexus for the subsidiaries selling the computers, since it contributes to the "establishment and maintenance" of the in-state market for sales of the computers. (States could document that customers would buy fewer computers from the Texas company if they were not assured that needed warranty repairs would be done on-site.) However, since the in-state warranty repair/networking subsidiary provides these services to more than one "business entity", that is, to both the subsidiary that sells desktop computers and the subsidiary that sells servers, under H.R. 1956 those activities no longer create BAT nexus outside of Texas for the Texas computer manufacturer.

- An increasing number of retail store chains are becoming so-called "bricks and clicks" businesses, that is, they are setting up subsidiaries to sell the same merchandise over the Internet. These businesses are also increasingly looking for ways that they can integrate the operations so that the stores facilitate greater purchases from the Web site (and vice-versa). Such strategies include accepting returns in the stores of unwanted merchandise purchased at the Web site, selling gift cards in the stores that can be redeemed at the Web site, allowing in-store pick-up of items purchased on the Web site, placing kiosks in the stores that can immediately be used to place orders at the Web site for merchandise that is not in-stock in the stores, and advertising the Internet address of the Web site in all the stores' advertising.[45] Most of these kinds of in-state activities conducted by the stores to enhance the sales of the Web sites go beyond the "solicitation" protected by Public Law 86-272. Moreover, under the Supreme Court's *Tyler Pipe* decision, the activities create BAT nexus for the Web subsidiary because they are "significantly associated with the [Web subsidiary] taxpayer's ability to establish and maintain a market in . . . [the] State[s where the stores are located] for [the Web subsidiary's] sales."

  Under H.R. 1956, however, the retail chain could easily ensure that the activities conducted by the stores and their employees to enhance purchasing from the Web site would not create BAT nexus for the Web site in the states in which the stores are located.[46] As in the previous example, all that the company needs to do is split the Web operation into two separate corporations and have each one be the nominal, legal seller of a portion of the company's product lines to final consumers.[47] Under such a structure, the stores would be conducting activities that help "establish and maintain the market in [the] state for more than one "business entity," thereby bringing themselves under the requirements of this nexus safe harbor in H.R. 1956. The two Web subsidiaries would remain free to contract with each other to share a common Web site, warehouses, and other operational requirements; in other words, taking advantage of this tax-avoidance opportunity would not entail significant out-of-pocket expenditures beyond some legal and accounting costs. As noted above, corporations have long routinely

subdivided their operations to take advantage of Public Law 86-272 alone; H.R. 1956 provides them with numerous additional tax minimization opportunities if they do so.

Of course, the "two business entities" provision of H.R. 1956 also enables out-of-state corporations to use *independent* in-state corporations to help them "establish and maintain a market" within a particular state without creating BAT nexus. For example:

- Under electrical utility deregulation implemented in some states, electricity consumers are free to contract for their electricity with independent power producers that own their own generating plants but not the distribution lines that actually enter customers' homes and businesses. The power generators are often outside the state(s) where their customers are located. The power producers must contract with the local utility that owns the distribution lines to deliver the electricity, read the customers' meters, and bill the customers. These activities performed by the local utility are critical to the ability of the out-of-state power generator to "establish and maintain a market" in its customers' state(s), and are therefore nexus-creating for the generator. However, if H.R. 1956 were enacted, the out-of-state power generators would no longer have BAT nexus in their customers' state(s) because the local utilities typically deliver power for more than one "business entity," that is, more than one independent generator. Even if a local utility delivered power for only a single independent generator, however, the latter could easily avoid nexus by dividing itself into two legal entities, for example, a subsidiary that sold power to business customers and a subsidiary that sold power to residential customers.

In sum, the attributional nexus-related language of H.R. 1956 effectively overrules the Supreme Court's *Tyler Pipe* decision and substantially broadens the nexus protections provided by Public Law 86-272. *Tyler Pipe* decreed that a corporation would have BAT nexus in any state in which it hired another business or individual to conduct activities on its behalf that were "significantly associated" with the corporation's ability to "establish and maintain" a market for its wares; under H.R. 1956, all the corporation needs to do to get around this holding is to make sure its wares are sold by at least two subsidiaries. Similarly, P.L. 86-272 provides that in-state "solicitation of orders" is the *only* activity that may be conducted "on behalf" of an out-of-state corporation by an in-state business without establishing income tax nexus for the out-of-state corporation; under H.R. 1956, *any* activities may be conducted in a state "on behalf" of an out-of-state corporation without establishing income tax nexus for the latter as long as "similar functions" are conducted "on behalf" of one other corporate subsidiary.[48]

Activity-specific Safe Harbors from Nexus

H.R. 1956 also contains a number of what might be called "activity specific" nexus safe harbors. These provide that the in-state presence of employees and/or property does not establish BAT nexus if the employees are engaged in or the property is used for certain

enumerated activities — even if both employees and property are present in the state for more than 21 days in a tax year.

Probably the most far-reaching of these activity-specific safe harbors is one that says that the in-state presence of equipment ("tangible personal property") owned or rented by an out-of-state corporation does not establish BAT nexus for the latter if it is being "used to furnish a service to the owner or lessee by another person." The following two examples illustrate how such a safe harbor could function to prevent the creation of BAT nexus by an out-of-state company and reduce its corporate income tax liability:

- A national Internet service provider like American Online has "local points of presence" (POPs) in thousands of communities across the United States. These are banks of modems, Internet routers, and related computer equipment that enable dial-up customers to connect to AOL's Virginia-based Web site without incurring the cost of a long-distance telephone call. If AOL itself owns this equipment, it creates BAT nexus in the states in which the POP is located. If a separate corporation (either an AOL subsidiary or an independent company) owns the equipment and leases it to AOL, states could still take the position that the activity is "significantly associated" with the ability of AOL to "establish and maintain a market" for its Internet access service in its customers' states and therefore still creates nexus for AOL.[49] If H.R. 1956 were enacted, however, AOL could retain ownership of this equipment yet allow it be used and maintained by a subsidiary or independent company to "furnish a service to the owner," that, is "local customer connectivity" services to AOL. AOL would not have BAT nexus outside Virginia despite having millions of dollars worth of property in other states. The ownership of most of the POP equipment does not increase AOL's corporate tax liability to Virginia, because most of it is not located in Virginia. (Like the large majority of states with corporate income taxes, Virginia determines the share of a corporation's nationwide profit taxable in Virginia by averaging the shares of the corporation's nationwide payroll, property, and sales located within its borders.) The existence of substantial AOL-owned property in a state in which AOL is not taxable creates substantial "nowhere income" — profit that is not taxed by any state.[50]

- A computer chip manufacturer owns several multi-billion dollar fabricating plants around the country. A substantial share of the value of the plants is in the chip-making equipment, which is considered "tangible personal property" rather than real estate. If H.R. 1956 were enacted, the manufacturer could form separate subsidiaries to own and operate each of those plants and pay the subsidiaries a service fee for its "contract manufacturing" services to the parent. However, the parent corporation would retain ownership of the chip-making equipment itself. As in the previous example, the presence of substantial property owned by the parent in a state in which the parent is not taxable would create "nowhere income" — profit that would go completely untaxed.

Finally, H.R. 1956 allows a business to have an unlimited amount of property and employees present in a state for an unlimited number of days in a tax year without creating BAT nexus, if they are engaged in several specified activities. Four of the six activities are significant safe harbors that likely would provide substantial tax benefits to a large number of corporations. Under H.R. 1956 nexus is not created by the presence of employees or property in a state in connection with:

- the "possible purchase of goods or services for the business;"[51]
- "gathering news and covering events for print, broadcast, or other distribution through the media;"
- "participation in educational or training conferences, seminars or other similar functions;"[52] and
- the assembling, manufacturing, processing, or testing of the property on behalf of its out-of-state owner.

These four safe harbors are likely to allow numerous corporations to have a substantial amount of property and a large number of employees in a state for an extended period of time yet remain exempt from the state's corporate income tax or other BAT. With respect to the fourth safe harbor, for example, it is quite common for businesses to retain ownership of valuable raw materials or partially-manufactured products while they are being further processed or assembled by another business in another state. Yet no amount of in-state property would be nexus-creating for the owner under this scenario, despite the police and fire protection provided to the property while it is in the state.

Similarly, covering a major sporting event like the Superbowl or the Olympics may require a TV network to have dozens or hundreds of employees and millions of dollars of equipment in a state for weeks or months. Yet despite the substantial state and local governmental services provided to those employees and property items, the network would not be subject to BAT in the state.

Moreover, H.R. 1956 states that the ownership or renting of real property that is "used ancillary" to these four activities does not establish BAT nexus. That suggests that a manufacturer could maintain a permanent purchasing office in a state, a TV network could maintain a permanent news bureau in a state, and any corporation could maintain a permanent employee training facility in a state without creating BAT nexus.[53]

It should be apparent from this Appendix that enactment of H.R. 1956 would have a far-reaching impact on the ability of state and localities to impose corporate profits taxes and other BATs on many out-of-state corporations that they currently have the authority to tax because the businesses have a substantial physical presence within their borders. The body of this report provides some additional examples of the corporate tax avoidance possibilities that enactment of this proposed legislation would open up.

Notes

[26] "Taxing authority of a state" is not defined in H.R. 1956, but the reference appears in a section of the bill titled "Jurisdictional standard for state and local net income taxes and other business activity taxes." Presumably, therefore, the entire section is intended to apply to local BATs as well as state BATs. Neither is the word "person" defined in H.R. 1956. Presumably it is intended to apply to all business entities (including corporations, limited liability companies, trusts, and partnerships) in addition to "natural persons" or individuals.

[27] Like H.R. 1956 itself, P. L. 86-272 applies to all income taxes imposed on all types of businesses and individual "sole proprietors." For the sake of readability and because the most significant impact of the legislation in revenue terms is associated with corporate tax payments, the discussion in this report generally refers to corporate income or profits taxes.

[28] A company-owned office, even if used just for solicitation of orders, is not protected by Public Law 86-272, and so a state is free to impose a corporate income tax on an out-of-state corporation with such an office within its borders. See Notes 29 and 53.

[29] Despite continuous litigation, more than 30 years elapsed after the enactment of P.L. 86-272 before the U.S. Supreme Court gave any guidance as to what activities were encompassed in the law's safe harbor for "solicitation" — the key term in the law that Congress nonetheless had not seen fit to define. In its 1992 decision in *Wrigley* v. *Wisconsin*, the Court made clear that activities "entirely ancillary to solicitation" (such as the presence of property used by salesmen) were also protected by P.L. 86-272. Interestingly, the Court implied that it would have interpreted P.L. 86-272 as protecting the in-state presence of a permanent sales office as well but for other language in the law that specifically sanctioned an in-state sales office owned by an independent contractor soliciting sales on behalf of an out-of-state company.

[30] These loan officers arguably also would be free to solicit *deposits* from the Maryland businesses, since another safe harbor in the bill states that the presence of employees to negotiate the possible purchase of goods and services for the business also does not constitute a "physical presence." Deposits could be characterized as intangible goods or services purchased by banks through the payment of interest.

[31] See: Multistate Tax Commission, "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272" (1986). Available at www.mtc.gov/UNIFORM/pl86-272_72701.pdf.

[32] The corporate income tax savings from avoiding creating nexus in a state can be enormous; indeed, depending upon the specific states involved, corporations can avoid taxation of *all* of their profits. Take, for example, a Connecticut manufacturer, all of whose customers are in Massachusetts. If the corporation can avoid creating nexus in Massachusetts, none of its profit will be taxable in either Connecticut or Massachusetts. If it establishes nexus in Massachusetts, its entire profit would be taxed in that state. See: Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities, revised May 2005, pp. 11-13 (discussing the tax consequences of the interaction of a single sales factor state corporate income tax apportionment formula and the absence of the "throwback rule").

[33] *Secretary of Revenue of North Carolina* v. *A&F Trademark, Inc., et al.*, North Carolina Tax Review Board, May 7, 2002. For a discussion of how widespread the use of intangible holding companies appears to be, see: Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, Center on Budget and Policy Priorities, revised May 21, 2003. Available at www.cbpp.org/4-9-02sfp.pdf. This report notes that the decision in the North Carolina *Limited* case revealed that this corporate group sheltered over $1 billion in profits from state taxation in a three-year period through the use of intangible holding companies.

[34] See: Robert T. Garrett, "Business Lobbyists Thwarting Efforts to Close Tax Loophole," *Dallas Morning News*, May 12, 2003. In a 2003 letter to members of the National Conference of State Legislatures, CRAFT questioned the relevance of this Texas experience to BAT nexus legislation, since the legislation itself would not prevent Texas from shutting down this tax shelter. To reiterate, Texas' experience demonstrates that if artificial restrictions on

taxing jurisdiction are created by *either* federal or state legislation, corporations will go to great lengths to restructure their operations to take advantage of any tax sheltering opportunities thereby created. As documented in this Appendix, the enactment of H.R. 1956 would create numerous such opportunities.

[35] See: U.S. General Accounting Office, *Unemployment Insurance: Survey of State Administrators and Contacts with Companies Promoting Tax Avoidance Policies*, GAO-03-819T, June 19, 2003.

[36] "State Releases Names of Firms that Avoided Unemployment Taxes," Associated Press story, July 9, 2004.

[37] See: H.R. 3463, the "SUTA Dumping Prevention Act of 2004," signed into law by President Bush on August 9, 2004.

[38] Splitting a corporation into multiple subsidiaries to take advantage of the safe harbor for "solicitation" created by Public Law 86-272 might be characterized as "State Tax Planning 101." In its section titled, "Basic Multistate Tax Planning," a major reference source on multistate corporate taxation observes: "When a corporation has only a limited connection with a state, it may be possible to discontinue that activity by using an alternative means of accomplishing the same result. . . . When nexus is created by sales representatives performing repair and maintenance services in the state, one strategy would be to separately incorporate the sales division that operates in the state." See the source cited in Note 9.

[39] Ellen E. Schultz and Theo Francis, "How Life Insurance Morphed into a Corporate Finance Tool," *Wall Street Journal*, December 30, 2002.

[40] As will be discussed below, one provision of H.R. 1956 arguably *would* allow certain businesses to have permanent physical facilities in many states without creating BAT nexus in such states. See Note 53.

[41] Letter from the Council on State Taxation to members of the U.S. House of Representatives in support of H.R. 2526, July 16, 2002. Emphasis added. H.R. 2526 was the version of BAT nexus legislation introduced in the 107th Congress.

[42] *Scripto* v. *Carson*, 1960.

[43] Admittedly, this provision is consistent with the other provisions of H.R. 1956. It would be illogical to allow a company to have its own employees and property in a state for up to 21 days for any purpose without creating nexus and yet not grant the same safe harbor to third parties engaging in the same activities on behalf of the same company.

[44] Such a subsidiary is sometimes termed a "captive procurement entity." See: R. Scot Grierson, "Related-party Transactions," *State Tax Notes*, December 6, 2004, pp. 659-660.

[45] See: Kortney String, "Shoppers Who Blend Store, Catalog and Web Spend More," *Wall Street Journal*, September 3, 2004.

[46] Again, there are a number of reasons why the corporation may wish to minimize the number of states in which the Web operation is subject to a corporate income tax or other BAT. In particular, the states in which the Web subsidiaries are located may have in place a combination of tax rules (a "super-weighted" sales factor and the absence of a "throwback" rule) that ensures that a substantial portion of any profits realized by the Web operation from selling in other states is not taxed by *any* state. (See the sources cited in Notes 5 and 32.) As was discussed in the body of the report, even if the all of the profits of the Web operation are taxable in the state(s) where it is located and the company obtains only a modest net tax savings from the restructuring described in the example, it remains the case that H.R. 1956 would block the ability of the states where the stores are located to tax their fair share of the profit of the Web site.

[47] Again, there is nothing far-fetched about this scenario; in fact, it is in widespread use today. For example, Amazon.com operates the entire online operation of a number of retail store chains, including Borders Books. Yet

Borders is the nominal seller of items purchased from www.borders.com; this arrangement is apparently aimed — at least in part — at ensuring that Amazon does not establish nexus in states in which Borders stores are located.

[18] It should also be noted that the "attributional nexus" provision of H.R. 1956 under discussion here would provide another way around the language of the bill that provides that BAT nexus *is* created for a corporation if its own employees and property are present in a state for more than 21 days (assuming state law so-provides). As discussed above, any corporation that wished to have employees in a state for more than 21 days could incorporate multiple subsidiaries to employ those workers (and, as also explained, the incorporation of 18 subsidiaries would allow year-round presence of employees without creating BAT nexus.) Alternatively, a corporation that wished to have employees permanently in a state for any purpose need only incorporate one subsidiary to employ them, again, so long as this subsidiary did the work for at least two other commonly owned entities. Thus, in the earlier example of the computer repair business (see p. 6), the business could avoid BAT nexus in all the states in which the repairs are conducted (except its headquarters state) by forming one subsidiary to employ the repair workers. This subsidiary is a subcontractor to two other subsidiaries that actually contract with final customers for the repair work — one subsidiary contracting with customers in states A, B, and C, and the other subsidiary contracting with customers in states D, E, and F. Since the subsidiary whose employees actually perform the repairs in the states is nominally doing so "on behalf" of two separate corporations, the presence of the repair people in the states does not establish nexus for the corporation on whose behalf they are working.

[19] At least two states, Tennessee and Connecticut, have taken AOL to court claiming that its local points of presence within their borders establish sales tax and/or BAT nexus. The Tennessee case is still pending.

[50] Just as they have with respect to sales occurring in a state in which the corporation is not taxable, states could in theory enact a property "throwback rule" that would assign the property for tax purposes to the headquarters state to nullify the creation of "nowhere income." However, corporations have succeeded in blocking roughly half the states from enacting the sales throwback rule, including stopping several concerted state legislative efforts in the past couple of years. Enactment of a property throwback rule would be unprecedented and, in a number of states, would require a supermajority of the legislature or a statewide referendum.

[51] It is difficult to interpret the import of the word "possible" in this provision of H.R. 1956. It might be intended to mean that if an employee present in a state for more than 21 days actually purchased a good or service for her out-of-state employer, it would create BAT nexus for the latter. If that is the intention, it could probably easily be circumvented by ensuring that the contract for the purchase was executed at the company's out-of-state headquarters. However, a section-by-section analysis of H.R. 3220 — the predecessor to H.R. 1956 — on the Web site of the lead sponsor, Representative Bob Goodlatte, contains a blanket statement that implies that actual purchasing of inputs is non-nexus-creating: "The following activities are exempted from the 21-day rule, such that businesses could assign employees in a State for an unlimited period of time and not be taxed if the activities are any of the following: Purchasing goods or services for the employer. . ."

[52] Note that this wording does not limit such participation to that of a "trainee;" it encompasses the trainer as well. Nor is it restricted to such events organized by independent companies or organizations. Accordingly, the language allows a corporation to conduct unlimited training of its own employees, customers, or potential customers in a state without creating BAT nexus — including training held at a company-owned facility (see Note 53). It would also seemingly immunize from taxation the numerous for-profit companies that travel around the country providing educational seminars, for example, sessions on retirement planning.

[53] The Coalition for Rational and Fair Taxation has disputed that the wording of these safe harbors allows the ownership or renting of brick-and-mortar facilities in which these activities are carried out. Citing the 1992 decision in *Wrigley* v. *Wisconsin* interpreting the scope of protected "solicitation" in Public Law 86-272, CRAFT has stated: "There is no basis for this concern. The U.S. Supreme Court has held that the ownership of real property, whether a sales office or facility, is not a protected activity." In *Wrigley*, however, the Court was interpreting the wording of P.L. 86-272 alone. Moreover, the Court implied that it might have interpreted protected "solicitation" as encompassing ownership of an office limited to that function but for an explicit granting of authority to own an office to independent contractors representing out-of-state sellers but not to the sellers themselves.

In any case, the *Wrigley* Court interpreted the totality of P.L. 86-272 as indicating Congress' "judgment that a company office within a State is such a significant manifestation of company 'presence' that, *absent a specific exemption*, income taxation [of the owner of the office] should always be allowed." [Emphasis added.] But H.R. 1956 *does* provide for a specific exemption; it states explicitly that "the leasing or owning of tangible personal property or real property in [a] state on more than 21 days" does not create nexus if it is "used ancillary to an activity" excluded from the 21 day limit, such as news gathering. In short, there is good reason to interpret H.R. 1956 as providing a nexus safe harbor even for the ownership of an office for news gathering, purchasing of inputs, or training company employees. This is an issue around which considerable litigation is likely to occur if H.R. 1956 is enacted.

LETTER TO THE HONORABLE CHRIS CANNON FROM ARTHUR R. ROSEN, COUNSEL, COALITION FOR RATIONAL AND FAIR TAXATION

COALITION FOR RATIONAL AND FAIR TAXATION

September 27, 2005

The Honorable Chris Cannon, Chairman
The Honorable Melvin Watt, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
Washington, DC 20015

Re: Hearing on H.R. 1956, the "Business Activity Tax Simplification Act of 2005"

Dear Chairman Cannon and Ranking Member Watt:

On behalf of the Coalition for Rational and Fair Taxation ("CRAFT"), I would like to thank you for this opportunity to submit this statement for the record for the September 27, 2005 hearing on H.R. 1956, the "Business Activity Tax Simplification Act of 2005." 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, employing hundreds of thousands of American workers and generating billions of dollars for the nation's economy.

CRAFT believes that a bright-line, quantifiable physical presence nexus standard is the appropriate standard for state and local taxation of out-of-state businesses and that modernization of Public Law 86-272 is essential for the health and growth of the American economy. Therefore, CRAFT strongly supports H.R. 1956 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 act to provide clear guidance to the states in the area of state taxing jurisdiction, remove the drag that the current climate of uncertainty places on American businesses, and thereby protect American jobs and enhance the American economy.

I. BACKGROUND OF THE BUSINESS ACTIVITY NEXUS ISSUE

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. Perhaps the hallmark of American federalism is this assignment of authority to the federal government (along with the responsibility for the related national monetary/fiscal system and for foreign affairs). 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 – I respectfully submit – Congress' responsibility. In addition to the Commerce Clause, this issue is also informed by the Due Process Clause of the Fourteenth Amendment. In the context of the Due Process Clause, the Supreme Court has determined that, in the area of state taxation, "the simple but controlling question is whether the state has given anything for which it can ask return."[1]

Unfortunately, some state revenue departments and state legislatures have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on businesses located in other states that have little or no connection to their state. Specifically, some state revenue departments have asserted that they can tax a business that merely has customers in the state based on the recently-minted notion of "economic nexus." Such behavior is entirely understandable on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state's society. But this country has long stood against such taxation without representation. And worse, 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 still, 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.[2]

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). Unfortunately, the latter choice is sometimes made, especially since some state revenue departments are making increasing use of "hardball" tactics, a topic on which I would truly relish elaborating at another time or in another forum. Moreover, the compliance burdens of state business activity taxation can be immense. Think of an interstate business with customers in all 50 states. 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 upon thousands of localities.

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[1] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

[2] *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).

There can be no doubt that the rapid growth of e-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 income and franchise taxes on out-of-state businesses that have little or no physical connection with the state or locality.

Consistent with principles enumerated by the Congressional Willis Commission report issued in 1965 and more recently by the majority report of the federal Advisory Commission on Electronic Commerce,[3] H.R. 1956 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. This issue has become increasingly pressing as the U.S. and global economies have become less goods-focused and more service-oriented and as the use of modern technology has proliferated throughout the country and the world. H.R. 1956 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. H.R. 1956 does not apply to other taxes, like personal income taxes,[4] gross premium taxes imposed on insurance companies, or transaction taxes, such as the New Mexico Gross Receipts and Compensating Tax Act and other sales and use taxes.[5]

The underlying principle of this legislation is that 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. By imposing a physical presence standard for business activity taxes, H.R. 1956 ensures that the economic burden of state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state. H.R. 1956 does so in a manner that ensures that the business community continues to pay its fair share of tax but that puts a stop to new and unfair tax impositions. Perhaps most important, H.R. 1956's physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners. In fact, creating consistency with the international standards of business taxation is vital to eliminating uncertainty and promoting the growth of the American economy.

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[3] *See* 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); and Advisory Commission on Electronic Commerce, "Report to Congress," pp. 17-20 (April 2000), respectively.

[4] In addition, nothing in H.R. 1956 affects the responsibilities of an employer to withhold personal income taxes paid to resident and nonresident employees earning income in a state or to pay employment or unemployment taxes.

[5] N.M. STAT. § 7-9-1 *et seq.*

A. *BRIEF HISTORY OF NEXUS BATTLES*

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.[6] In many ways, the issues before the Subcommittee had their birth from 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.[7] Prior to that time, there had been a "well-settled rule, stated in *Norton Co. v. Illinois Dept. of Revenue*, 340 U.S. 534 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place."[8] The Supreme Court's 1959 decision in *Northwestern States Portland Cement*, coupled with the Court's refusal to hear two other cases[9] (where the taxpayers, who did not maintain offices in the state, conducted activities in the state that were limited to mere solicitation of orders by visiting salespeople), cast some doubt on that "well-settled rule" and fueled significant concern within the business community that the states could tax out-of-state businesses with unfettered authority, thereby imposing significant costs on businesses and harm to the American economy in general. 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.[10] 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.[11]

B. *AND IN PRESENT DAY, THE BATTLES WAGE ON . . .*

In the forty-six years after the flurry of activity resulting from the *Northwest Portland Cement* decision, there have been marked transformations in the global economy yet we are no closer to a definitive answer on the question that brings us here today, namely, 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

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[6] *See, e.g.*, Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 Tax Law. 37 (1987).

[7] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

[8] *Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).

[9] *Brown Forman Distillers Corp. v. Collector of Revenue*, 101 So.2d 70 (La. 1958), *appeal dismissed and cert. denied*, 359 U.S. 28 (1959); *International Shoe Co. v. Fontenot*, 107 So.2d 640 (La. 1958), *cert. denied*, 359 U.S. 984 (1959).

[10] P.L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).

[11] 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).

physical presence in the state whatsoever.[12] This "economic nexus" theory 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 and other members of the business community believe that a state can impose direct taxes only on businesses that have a physical presence in the state.[13] The state courts and tribunals have rendered non-uniform decisions on this issue.[14] The Supreme Court has not granted writs of certiorari in relevant cases.[15]

The bottom line is that businesses should pay tax where they *earn* income. It may be true, as certain state tax collectors assert, that without sales there can be no income. While this may make for a nice sound bite, it simply is not relevant. Income is earned where an individual or business entity employs its labor and capital, *i.e.*, where he, she, or it actually performs work.[16]

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[12] 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: 2005 Survey of State Tax Departments*, 12 Multistate Tax. Rep't 4, pp. S-4 - S-53, at S-20-S-21 (April 22, 2005). *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).

[13] 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 h 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.); Jurisdiction to Tax - Constitutional, Council of State Taxation Policy Statement of 2001-2002; The Internet Tax Fairness Act of 2001: Hearing on H.R. 2526 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary, 107th Cong. (2001) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair Taxation; Stanley Sokul, Member, Advisory Commission On Electronic Commerce, on Behalf of the Direct Marketing Association and the Internet Tax Fairness Coalition). *See also* Scott D. Smith and Sharlene E. Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 25 State Tax Notes 787 (Sept. 9, 2002). *See also* Doug Sheppard, *The Certainty of Disagreement on Business Activity Tax Nexus*, 25 State Tax Notes 420 (Aug. 5, 2002).

[14] *See MBNA America Bank v. State Tax Commissioner*, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), *rev'd*, No. 04-AA-157 (W.Va. Cir. Ct. June 27, 2005), *appeal pending; J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Lanco, Inc. v. Director, Division of Taxation*, Superior Court of New Jersey, App. Div., Dkt. No. A-3285-03T1 (Aug. 24, 2005), *rev'g*, 21 N.J. Tax 200 (N.J. Tax Ct. 2003); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. petition filed*, Dkt. No. 04-1625 (June 6, 2005); *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993); *Acme Royalty Co. v. Missouri Dir. of* Revenue, 2002 Mo. LEXIS 107 (Mo. 2002); *Rylander v. Bandag Licensing Corp.*, Tex. App. Ct., No. 03-99-004217-CV (May 11, 2000); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995) (*cf. Lanzi v. State of Alabama Department of Revenue*, Ala. Dep't of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003); and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

[15] *Comptroller of the Treasury v. SYL, Inc.; Crown Cork & Seal Co. (Del.), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied* 2003 U.S. LEXIS 8044 (2003) and 2003 U.S. LEXIS 9221 (2003); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993).

[16] 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)).

In fact, as early as 1919, the Attorney General of the State of New York pointed out that "the work done, *rather than the person paying for it*, should be regarded as the 'source' of income."[17] For example, suppose an individual spends three years working in his or her home building a new sophisticated machine. To accomplish this, the individual uses a large of amount of equipment and employees in his or her home state. When the inventing, designing, and manufacturing are completed, the individual then engages in a nationwide advertising program to market the sale of the machine. If the ultimate buyer happens to be located in a neighboring state (or for that matter in a state across the country), there is absolutely no reason why the buyer's state should be able to impose tax on the individual selling the item – the individual *earned* the income in his or her home state.

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 (and individuals) are members of the American society and pay federal taxes for such general benefits and protections. Nevertheless, some argue that states have spent significant amounts of revenue to maintain an infrastructure for interstate commerce and court systems that the nation can utilize, not to mention spending trillions of dollars over the years to provide education to their populations. This argument continues with the incredible example of the student who benefits from his or her state's education funding and who may someday work for an out-of-state company; apparently, the out-of-state company would then receive benefits that had been provided by that employee's former state and should therefore bear some of the burden by paying tax to the state that provided the education. The absurdity of this position should be clear. Should U.S. companies that have hired people educated in Switzerland have to pay Swiss taxes? Should every business automatically be obligated to pay taxes to all 50 states, in anticipation of the possibility, however remote, that they may at some undefined future point hire a person who was educated in the taxing state? No one can argue that the states do not play an important role in interstate commerce, that an educated public is not an element of a fruitful society and marketplace, or even that a court system does not help to promote order. But this simply cannot be a basis for states to impose tax on all businesses in the nation. Imposing business activity taxes on out-of-state businesses is truly "taxation without representation."[18]

II. ENDING THE WAR: H.R. 1956

A. *PROVISIONS OF H.R. 1956*

1. CODIFICATION OF THE PHYSICAL PRESENCE STANDARD

H.R. 1956 provides that, pursuant to the authority granted to Congress under the Commerce Clause, a state or locality may not impose business activity taxes on businesses that do not have a "physical presence" within the taxing jurisdiction. The requisite degree of physical presence

[17] Op. N.Y. Att'y Gen. 301 (May 29, 1919) (emphasis added).
[18] 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

(employees, property, or the use of third parties to perform certain activities) is set at greater than 21 days during a taxable year, with certain specified incidences of presence being disregarded as qualitatively *de minimis*. The fact that a business used to have (but no longer has) a physical presence in a state is not sufficient grounds for imposing a business activity tax. The 21-day limitation is a quantitative *de minimis* standard, which is both appropriate and consistent with the principle that a person should be subject to tax only to the extent it has received the benefits and protections of a state.

The 21-day limitation is measured by each day that a business assigns one or more employees in the state, uses the services of certain third parties in the state, or has certain property in the state. For example, a business that sends only four employees into a state for ten days will not have a physical presence in that state. On the other hand, a business that sends one employee into a state on twenty-two different days during a taxable year will have physical presence in that state. Compliance with and administration of this standard would be simple and straightforward.

There are two exceptions to the 21-day rule that apply to those who really do earn their income during shorter visits to the state. The first exception ensures that businesses engaging in actual selling of tangible personal property through the use of traveling employees, *e.g.*, businesses that hold "tent sales" or "off-the-truck sales," or in performing certain services to physically affect real property in the state through the use of traveling employees, *e.g.*, migrant painters or roofers, are subject to state and local business activity taxes. As a result of this provision, H.R. 1956 does not substantially affect current law regarding the taxation of such businesses. The second exception is targeted at athletes, musicians, and other entertainers. Such persons are not eligible for the *de minimis* exceptions (and, thus, are subject to tax by the jurisdiction in which they perform). Both of these exceptions are consistent with the underlying intent of H.R. 1956 that businesses pay tax where income is actually earned.

For a qualitative *de minimis* standard, H.R. 1956 provides that certain property or certain activities engaged in by a business' employees within the jurisdiction's boundaries will not be considered in determining whether a business has the requisite physical presence in the jurisdiction. This approach of disregarding certain activities for nexus purposes has already been recognized in Public Law 86-272, where Congress has determined that mere solicitation is qualitatively *de minimis* relative to the benefits of protecting such activities offers to the American economy as a whole.[19] Under H.R. 1956's qualitative *de minimis* provisions, the

[19] Even the OECD Model Tax Convention, which is benchmark for the international jurisdictional standards for taxation, recognizes that certain activities should be disregarded. Like H.R. 1956, the OECD Model Tax Convention employs a physical presence jurisdiction standard by requiring that, before a source country may impose an income tax on a non-resident business' commercial profits, the business must have a "permanent establishment" in the source country. The definition of permanent establishment creates a rather high threshold for taxation (much higher than the standard that would be imposed by H.R. 1956). Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, Articles 5, 7 (Jan. 28 2003) ("OECD Model Tax Convention"). Like H.R. 1956, the OECD Model Tax Convention recognizes that there are certain situations that simply do not rise to the level of creating a taxable presence in the state. For example, a "permanent establishment" is not created by the maintenance of either "a stock of goods or merchandise belonging to the enterprise solely for

protected activities are limited to situations where the business is *patronizing* the local market (*i.e.*, being a customer), and thereby generating economic activity in the state that produces other tax revenues for the state, rather than *exploiting* that market (many states have issued rulings, albeit inconsistent and *ad hoc* in nature, recognizing this principle). This encompasses visiting current and prospective suppliers, attending (in contrast to hosting) conferences, seminars, or media events, utilizing an in-state manufacturer or processor, or having testing performed in the state. The principle underlying the exclusion of such activities is that the business, in its role as a consumer, is not directly generating any revenue in the state from these activities but, rather, is contributing to the income and economic health of the in-state business (income upon which the in-state business will be taxed by the state). Indeed, from a policy perspective, it makes little sense to impose tax on out-of-state businesses that choose to use the services or purchase products from an in-state company. Doing so creates a disincentive for out-of-state businesses to patronize in-state businesses, thereby negatively impacting the local market and tax revenues. By protecting these activities, H.R. 1956 protects the free flow of interstate commerce. Finally, establishing these protected areas does not create any complexity because each of the areas is quite discrete and clearly defined.

In the area of attributing one business' physical presence in a state to another, H.R. 1956 provides that an out-of-state business will be considered to have a physical presence in a state if that business uses the services of an in-state person, on more than 21 days, to perform services that establish or maintain the putative taxpayer's market in that state, unless the in-state person performs similar functions for more than one business during the year. The ownership relationship between the out-of-state person and the in-state person is irrelevant for purposes of this provision. By limiting attribution of nexus only to situations involving market enhancing activities, H.R. 1956 not only more accurately reflects the economics of a transaction or business, but is also consistent with the current state of the law. Expanding attribution any further would undermine the principles of fairness and equity in taxation. From a policy perspective or from an economic theory perspective, attribution of nexus between two separate and distinct persons is never appropriate.[20] This is because an in-state person conducting activities in a state for an out-of-state person pays tax to that state on its own income – which reflects the amounts paid by the out-of-state person to the in-state person for the value of the activities actually conducted in the state.

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the purpose of processing by another enterprise" or "a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise." OECD Model Tax Convention, Article 5, § 4. The first of these exceptions is comparable to one of the qualitative *de minimis* provisions of H.R. 1956 while the second exception presents a situation that would not even be protected by the provisions of H.R. 1956; H.R. 1956 would, however, protect the activities in the second exception if the out-of-state business did not maintain a fixed place of business in the state. *See* H.R. 1956, Secs. 3(b)(3)(A) and Secs. 3(b)(1)(A), (B).

[20] 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).

As an example, suppose an out-of-state sales company uses an affiliated manufacturer in a state to manufacture a product that the out-of-state business will sell outside of the state of manufacture. The manufacturer is conducting a business activity within the state and there is no doubt that it should be subject to tax by the state. That state will receive tax revenues commensurate with the manufacturing activities that actually occur in the state; the tax revenues will be based on the compensation, set at fair market value, that the manufacturer receives from the out-of-state sales company for its manufacturing services. As for the out-of-state sales company, its selling activities constitute a separate business activity that takes place outside of the state of manufacture. The selling activity generates a certain amount of income (*i.e.*, the sales price of the product less what the selling company paid to the manufacturer for its services) that will be subject to tax in the jurisdictions where the activities actually take place, *i.e.*, where the sales activities add value in the economic stream. Putting this example in a global context, attempts by the state of manufacture to tax the out-of-state sales company would be akin to Taiwan attempting to impose tax on the sales income of every U.S. business that contracts with a Taiwanese manufacturer to make products to be sold in the United States. It is simply too attenuated to argue that using the services of the in-state manufacturer subjects the out-of-state business to tax as well.

2. MODERNIZATION OF PUBLIC LAW 86-272

As mentioned earlier, the economy has undergone significant changes since Public Law 86-272 was enacted in 1959. In addition to codifying the physical presence nexus standard, the H.R. 1956 modernizes the longstanding protections of Public Law 86-272 to include *all* sales and transactions, not just sales of tangible personal property.[21] These provisions bring Public Law 86-272 into the 21st century by recognizing the shift in the focus of the global economy from goods to services and the increased importance of intellectual property.

H.R. 1956 also ensures that Public Law 86-272 covers *all* business activity taxes, not just net income taxes. This modernization provision addresses the efforts of some aggressive states to avoid the restrictions on state taxing jurisdiction as legislated by Congress in Public Law 86-272 by establishing taxes on business activity that are measured by means other than the net income of the business. Two examples are the Ohio Commercial Activity Tax ("CAT"), which was enacted effective July 1, 2005 to impose a gross receipts tax and the New Jersey Corporation Business Tax, which was amended effective in 2002 to impose a gross profits/gross receipts tax.[22] What is most distressing about the New Jersey amendments is that, after June 2006, these

[21] It is important to note that the business activity tax nexus provisions of H.R. 1956 and Public Law 86-272 are two separate constraints on state taxation of interstate commerce. Each law operates independently of the other. Thus, any activities protected by Public Law 86-272 as modernized by H.R. 1956 will not create a physical presence for that business, regardless of whether the protected activities occur in the taxing jurisdiction on more than 21 days.

[22] Other examples are the Michigan Single Business Tax and the taxable capital portion of the Texas corporate franchise tax. *See Gillette Co. v. Michigan Dep't of Treas.*, 497 N.W.2d 595 (Mich. Ct. App. 1993) and *Guardian Indus. Corp. v. Michigan Dep't of Treas.*, 499 N.W.2d 349 (Mich. Ct. App. 1993) (P.L. 86-272 does *not* apply to the SBT because the SBT is not a net income tax but a tax on the privilege of a company to conduct business activities in the Michigan) and *INOVA Diagnostics, Inc. v. Strayhorn*, No. 03-04-00503-CV (Tex. Ct. App. May

"gross" taxes will apply *only* to businesses protected by Public Law 86-272. In other words, New Jersey has effectively circumvented the Congressional policy decision underlying the enactment of Public Law 86-272 by imposing a non-income tax only on those businesses that would otherwise be protected. While other states have not yet enacted such a targeted end-run around Public Law 86-272 as New Jersey, the enactment of the Ohio CAT is an indication that states are increasingly considering enacting non-income-based business activity taxes.[23]

B. *COMPARISON TO CURRENT COMMON LAW*

The physical presence nexus standard in H.R. 1956 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" 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.[24] This is because under the American legal system, a court only has the authority and responsibility to address the case before it. The Supreme Court has not granted a writ of *certiorari* to a case that would permit it to address the business activity tax nexus issue. So what constitutes substantial nexus for business activity taxes?[25]

Since the 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

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26, 2005) (Public Law 86-272 exempts earned surplus from taxation but the taxpayer remained subject to the net taxable capital portion of the Texas corporate franchise tax).

[23] Another example is the 2003 budget proposal by Kentucky's Governor Paul Patton that would have replaced Kentucky's corporate income tax with a "business activity tax" that would tax a company's payroll paid in Kentucky and gross receipts from sales in Kentucky, even those of out-of-state businesses. *See Securing Kentucky's Future*, State of Kentucky, Office of the State Budget Director (January 2003). The Kentucky legislature ultimately did not adopt Governor Patton's budget.

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

[25] Opponents of a physical presence standard cite *International Harvester*, a 1944 United States Supreme Court case, as support for their position that economic nexus is appropriate. *See International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944). Reliance on this case is simply not appropriate because to do so ignores over 60 years of subsequent jurisprudence (*e.g.*, *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977) and *Quill*). But even more fundamentally, the case involved a Due Process analysis and never considered the requirements of the Commerce Clause. In addition, when read in the proper context, it is clear that *International Harvester* does not endorse an economic presence standard for business activity taxes. In fact, *International Harvester* concerned the ability of Wisconsin to require a corporation with a physical presence in the state to withhold tax on dividends that it paid to its shareholders. Further, the imposition of liability on the corporation can be seen as merely a delayed income tax on the physically present corporation. Clearly, this case is not to be relied upon to determine the appropriate nexus standard for business activity taxes.

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, so if anything, the consequent greater economic burden should require a greater connection with the taxing state (as the Supreme Court *see*ms to have recognized).[26] Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes.[27] Sales and use taxes typically involve only two jurisdictions (the state of origin and the state of destination). However, corporate business activities often create contacts with many states. Most of the state-level decisions on this issue have concluded that there is no principled reason for there to be any lower standard for business activity taxes than for sales and use taxes.[28] Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.

III. OTHER CONSIDERATIONS

A. *FEDERALISM*

Contrary to the arguments of some opponents of clarifying the standards for state business activity taxes,[29] considerations of federalism support passing this legislation. A fundamental aspect of American federalism is that Congress is given the authority and responsibility to ensure

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[26] "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)).

[27] *See, e.g.*, *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (U.S. 1977).

[28] 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*, Ala. Dep't of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003)).

[29] *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. Interestingly, some of these same critics of H.R. 1956 recognize Congress's authority to legislate in the area of multistate taxation. For example, the National Governor's Association ("NGA") is currently supporting Congressional intervention in the multistate tax arena in two instances. The first involves the NGA's efforts to encourage Congress to enact legislation that would override *Quill's* physical presence requirement for sales and use taxation collection obligations. (Like H.R. 1956, such legislation addresses *when* a state can require a business to collect sales and use taxes and not *how* a state may define its sales and use tax base.) The second is the NGA's support of S. 1066, the "Economic Development Act of 2005," which would permit states to provide tax incentives for economic development purposes (thereby overriding the decision of the United States Court of Appeals for the Sixth Circuit in *Cuno v. DaimlerChrysler*). The NGA and other supporters of these two legislative measures cannot fairly invoke the federalism argument to oppose H.R. 1956 while failing to embrace the same principle in support for Congressional intervention to override judicial decisions affecting other matters of multistate taxation.

that interstate commerce is not burdened by state actions (including taxation of such commerce).[30] The Founding Fathers, by discarding the Articles of Confederation and establishing a single national economy, intended for Congress to protect the free flow of commerce among the states against efforts by individual states to set up barriers to this trade. Congress itself has recognized this numerous times in the context of state taxation and has exercised its responsibilities repeatedly by enacting laws that limit the states' authority to impose taxes that would unreasonably burden interstate commerce.[31] Some critics argue that such measures are too restrictive and violate principles of federalism.[32] 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.[33] Moreover, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[34]

H.R. 1956 simply codifies the traditional jurisdictional standards for when a state or local government may impose a tax on a business engaged in interstate commerce; the bill does nothing to determine how a state may tax businesses that are properly subject to its taxing jurisdiction. A state remains free to determine what type of tax to impose, be it an income tax, a gross receipts tax, a value added tax, or a capital stock tax; to determine how to apportion the income that is taxed in the state, be it a single- or three-factor formula based on property, payroll

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[30] *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).

[31] A few other examples include the Federal Aviation Act, which prohibits states and localities from levying a ticket tax, head charge, or gross receipts tax on individuals traveling by air, provides that airline employees may be taxed only in their state of residence and the state in which they perform at least fifty percent of their duties, allows only states in which an aircraft takes off or lands to tax the aircraft or an activity or service on the aircraft, and prohibits state "flyover" taxes; the Mobile Telecommunications Sourcing Act, which prohibits states from taxing mobile telecommunications service unless the state is the user's place of primary use of the service; the Amtrak Reauthorization Act of 1997, which prohibits states from taxing Amtrak ticket sales or gross receipts; Public Law 104-95, which prohibits states from taxing pension income unless the pensioner resides in that state; the ICC Termination Act of 1995, which prohibits states from taxing interstate bus tickets; the Miscellaneous Revenue Act of 1981, which prohibits states and localities from imposing property taxes on air carriers' property at a higher rate than that which is imposed on other commercial or industrial property in the state; the Railroad Regulatory Reform and Revitalization Act of 1976 (the "4R Act"), which prohibits states from imposing differing taxes on railroad property; and the Soldiers and Sailors Civil Relief Act of 1940, which limits state taxation of members of the Armed Forces to the member's state of residence, prohibiting different states in which the member may be stationed from also taxing that member. For a detailed list of instances where Congress has exercised its authority under the Commerce Clause, *see* Frank Shafroth, *The Road Since Philadelphia*, 30 State Tax Notes 155 (October 13, 2003).

[32] *See Federalism at Risk: A Report by the Multistate Tax Commission*, Multistate Tax Commission (June 2003); *Respecting Federalism*, Multistate Tax Commission Policy Statement 03-01.

[33] *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).

[34] *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.").

and/or sales; to set the rate at which the chosen tax will be imposed; to determine whether or not to follow federal taxable income, *e.g.*, to choose whether to decouple from federal bonus depreciation; to provide credits or deductions for certain types of expenses; and so on. H.R. 1956 merely confirms that the ability of states to tax is subject to constitutional limitations. Thus, H.R. 1956 strikes the correct balance between state autonomy/sovereignty and interstate commerce.

The economic nexus standard asserts that a business is subject to and liable for business activity tax if that business has derived revenue or income from a customer in a state – even though the business has conducted no activities in the state (*i.e.*, has had no property or employees located in that state). Keeping in mind that every buyer in a free market economy benefits from the purchase-sale transaction as much as the seller, the economic nexus standard effectively imposes a toll charge on out-of-state businesses for exchanging cash for property or for the provision of a service. Such a tax acts as a tariff on interstate commerce and creates exactly the problem that existed under the Articles of Confederation and that led to the adoption of the Constitution. Under the Articles of Confederation, state taxes and duties impeded interstate commerce as states began enacting their own tariffs and taxing interstate commerce, thereby putting up trade barriers to free trade.[35] This led to some states retaliating by banning products from other states. By effectively imposing such toll charges, the economic nexus standard will clearly have a negative impact on 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 sufficient reason to establish a physical presence nexus standard. The United States and its tax treaty partners have, for decades, adopted and implemented a "permanent establishment" rule. The "permanent establishment" concept is a long-standing global principle and has been extremely important to U.S. businesses and, thus, to the American economy.

The "permanent establishment" rule provides that neither country that is a party to the treaty will impose an income tax on a business from the other country unless that business maintains a substantial physical presence in the taxing country. Using the U.S. Model Treaty provisions as an example, a foreign business must have a "fixed place of business [in the United States] through which the business of an enterprise is wholly or partly carried on" before the United States may impose a tax on that business.[36] Under this standard, neither a "rep office" staffed by a few people, nor a facility used for storage, nor the maintenance of goods or merchandise for processing by another business would rise to the level of being a "permanent establishment" in the United States sufficient for the imposition of federal income tax on that business.

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. It is significant that the

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[35] *See, e.g., Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 11 (1824); *Quill v. North Dakota*, 504 U.S. 298, 313 (1992).
[36] United States Model Income Tax Convention of September 20, 1996, Art. 5.

OECD has recently studied the issue and preliminarily concluded that the "permanent establishment" rule should remain the proper standard for international tax treaties even with the proliferation of electronic commerce.[37] The policy reasons underlying such a conclusion are clear. Imagine for a moment that a foreign country tried to tax the profits of U.S. companies simply because the U.S. firms exported goods to that country. There is no doubt that the United States government and business community would be outraged and that the American economy would be dramatically injured. The economic nexus standard that the states would like to implement would have a similar effect on interstate commerce.

Unfortunately, it has been said that some countries, citing the efforts of U.S. state revenue departments to impose direct taxes on any business that has customers within the state's borders, are now saying that they want to renegotiate their treaties with the United States so they can begin taxing every U.S. business that has a customer in their country. This would be a disaster for the American economy. Enactment of H.R. 1956, which includes a nexus standard that is analogous to those found in U.S. tax treaties, is essential for ensuring that the current international system of taxation remains intact.

C. *INTERPLAY WITH STATE TAX INCENTIVES*

States have been increasingly active and competitive in offering tax incentive packages to businesses to locate and/or expand their operations in that state. Such incentives are offered not only to entice businesses into a state but also to ensure that businesses already located in the state do not relocate to, or expand in, other jurisdictions. The in-state company receives the benefits and protections provided by the state and, absent the incentives, would therefore be properly subject to full taxation.

When combined with the economic nexus standard, states would actually be subsidizing such incentives for in-state businesses at the expense of out-of-state businesses that do not receive the benefits and protections of the state. Not only does this offend the basic principle of

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[37] The expanded Commentary on permanent establishments, which is expected to be finalized this year states:

> Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

In short, the OECD working group determined that a company does not have a permanent establishment in a foreign jurisdiction merely because that company receives an economic benefit from a foreign company does not mean that the foreign company constitutes a permanent establishment. This is consistent with the qualitative *de minimis* standards of H.R. 1956. *See Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?,* Organisation for Economic Co-operation and Development, Technical Advisory Group on Monitoring the Application of Existing Treaty Norms For Taxing Business Profits, Public Discussion Draft (Nov. 26, 2003).

nondiscrimination that is required by the Commerce Clause of the U.S. Constitution,[38] but, in addition, it surely is misguided tax policy to make one party that is not really "in" the jurisdiction bear the tax burden of those persons who actually receive the benefits and protections of the government services that the taxes are funding.

D. EFFECT ON AMERICAN JOB RETENTION AND GROWTH

The American economy has been making strong gains in the overall level of growth, with historically low inflation, home ownership at record levels, and household consumption expanding. These economic gains have been due in large part to the ongoing expansion in the productivity of U.S. workers and businesses. While productivity gains are unquestionably a good thing for the American economy, the flip side is that U.S. businesses have proven capable of increasing output without expanding employment at the same rate as *seen* in most past recoveries. Therefore, responsible federal policymakers need to identify and rectify potential barriers to new job creation in America to ensure that our economic expansion creates the largest number of high-quality jobs.

The current level of uncertainty and ambiguity in the application of state-level taxes on U.S.-based businesses impedes new job creation. Businesses operating in the U.S. must deal with the ambiguity in the current nexus rules that govern when states have the right to impose direct taxes on businesses. Rather than a clear set of federal rules regarding when a business is subject to state taxes, the current environment is governed largely by the level of aggressiveness of state tax administrators and ongoing litigation. State tax officials have increasingly pushed the envelope in an effort to raise revenues from out-of-state enterprises. The uncertainty will only increase as states continue to assert jurisdiction over out-of-state businesses based on "economic nexus" principles.

It is noteworthy that this uncertainty is borne chiefly by businesses based in the United States. Investing in the creation of new plants, equipment, and jobs in other countries is actually encouraged by the ambiguity in nexus standards and the aggressiveness of state tax officials. When combined with the effect of bilateral tax treaties and the difficulty of collecting state-level taxes from foreign enterprises, the uncertainty and ambiguity of state taxation has become another incentive that unnecessarily promotes new investment and job creation abroad.

Foreign business enterprises are often shocked to learn that while treaties may insulate them from federal taxation, state taxation can still be imposed. This factor, when combined with the ambiguity of current state tax nexus law and the aggressiveness of state tax administrators, has put a real damper on foreign investment. Even when a foreign business initially considers opening an active business in the United States and paying federal tax and state tax where it locates its property and employees, the specter of having to pay tax to every jurisdiction where it merely has customers is quite intimidating. Addressing the problems of state tax uncertainty and

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[38] *See, e.g., Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984).

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.

By providing a bright-line, quantifiable physical presence standard, H.R. 1956 addresses the current level of uncertainty in the nexus rules that apply to direct business taxes by lowering litigation expenses for companies that operate facilities in the United States and by reducing the likelihood that they will be targeted by out-of-state tax authorities bent on raising revenues from businesses that do not have a presence in their state. H.R. 1956, while certainly not an answer to all the questions related to encouraging new job creation in America, will encourage businesses, whether based in America or overseas, to put new investment and create new jobs here in America rather than in another country.

IV. CROSSING SWORDS: RESPONSE TO REVENUE & TAX PLANNING "ATTACKS"

A. *EFFECT ON STATE REVENUES*

There simply is no basis for the assertion that H.R. 1956 could lead to any meaningful loss of state revenues, much less the $10 billion revenue loss of that has been bandied about by state tax officials and organizations.[39] H.R. 1956 does not depart to any significant degree from what is now being done in the states. This has been confirmed by the former executive director of the Multistate Tax Commission.[40] A physical presence standard merely ensures that businesses are taxed only by those states that provide benefits and protections (*i.e.*, by those states in which businesses have property or employees). Outside the context of passive investment companies,[41] which have been characterized as "tax shelters" by many state officials, state revenue departments simply have not been successful in their attempts to assert economic nexus to impose tax on businesses that do not have a physical presence in the state.

H.R. 1956 would have no effect on taxes derived from businesses that maintain a facility or inventory in the jurisdiction for more than 21 days during the taxable year. Clearly, state and local governments derive most – if not virtually all – of their business activity tax revenue from

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[39] Dolores W. Gregory, *New MTC Chief Names Top State Issues: SSTP, BAT Bills and Federal Tax Reform*, 179 DTR G-8 (2005) ("The BAT proposal would create a physical presence standard for states to impose income and other business activity taxes on interstate commerce. If it is enacted as written, states stand to lose between $7 billion and $10 billion from various carve-outs in the legislation, Huddleston said.")

[40] "It *seems* to me that the states need to face the reality that most of them are generally incapable of enforcing the 'doing business' standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway." Eugene F. Corrigan, *States Should Consider Trade-Off on Remote-Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

[41] It is interesting to note that the states have now moved on to using other, more effective attacks against passive investment companies, such as the economic substance and *alter ego* arguments, combined reporting, and the denial of the relevant deductions. *See* Mitchell J. Tropin, *States Moving Away From 'Geoffrey,' Using Sham Arguments, 'Attribution' Nexus*, Daily Tax Report, No. 27 (Feb. 10, 2003).

such businesses. The amount of revenue received by taxing jurisdictions from those businesses that maintain no office, store, warehouse, or other facility – or even inventory – in the jurisdiction at all must truly be minimal.

Consider first states that impose a net income tax to which Public Law 86-272 applies. It is difficult for tax practitioners, corporate tax managers, and several government officials who were queried to believe that these states are actually collecting any material amount of revenue from businesses that have no office in the state and have non-solicitation employees in the state for zero to 21 days during the year. There simply cannot be many businesses paying such taxes and, thus, any revenue loss would be negligible. And while the modernization of Public Law 86-272 will extend to businesses soliciting sales of services and other types of property that are currently subject to tax in a state, the amount of tax that is actually being collected by that state is likely minimal. This is because most state apportionment formulas apportion receipts from services based on "cost of performance," which will likely mean that the virtually all of the business' receipts are sourced outside of the state (*i.e.*, where the services are performed and the properly and all operating and management employees are located).

Consider next those states, such as Michigan, New Jersey, Texas, and Washington, that impose business activity taxes that are not solely based on net income and, thus, are not covered by current Public Law 86-272. These states are currently able to collect revenue from out-of-state businesses that do not themselves maintain an office or other facility in the state but that employ individuals in the state who perform solicitation in the state. Modernizing Public Law 86-272 to cover non-income taxes clearly means that such states will no longer be able to collect this revenue. The amount of tax paid by such businesses, however, surely must be minimal because it is unlikely that businesses are paying business activity tax to states in which they only have a fleeting presence (in any event, the apportionment percentage would necessarily be quite small). It is essential to keep in mind that H.R. 1956 is based on the principle that a business engaged in interstate commerce should pay its fair share of tax.[42] H.R. 1956 does not *see*k to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the appropriate jurisdiction.

One of the difficulties that the business community has with the revenue estimates is that there is little empirical data showing where such extensive revenue losses would come from. With respect to charges that H.R. 1956 as currently drafted, it is interesting to note that the critics have charged that H.R. 1956 would cause up $10 billion in revenue loss "from various carve-outs in the legislation."[43] As explained below, the basis for any assertions appear based on flawed interpretations of the provisions of the legislation, and wrapped up in tax sheltering accusations

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[42] A recent study commissioned by the Council on State Taxation found that businesses (not including pass-through entities) paid $378.9 billion in state and local taxes in 2002, an amount that was considered to be at least business' fair share of tax. *See* Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, *A Closer Examination of the Total State and Local Business Tax Burden*, 27 State Tax Notes 295 (Jan. 27, 2003).

[43] Dolores W. Gregory, *New MTC Chief Names Top State Issues: SSTP, BAT Bills and Federal Tax Reform*, 179 DTR G-8 (2005).

to add political "heat."[44] Bear in mind that the statements of revenue impact made by certain state revenue departments and their representatives have been shown to be highly unreliable because the "estimates" focus on *potential* effects from *hypothetical* restructurings by businesses, are based on *hypothetical* changes in state law, or cite to *potential* impacts on apportionment rules (which is an issue of how much to tax, not whether to tax).[45] Such considerations do not make for a reliable or accurate revenue estimate because: (1) revenue impact analysis should be formed based on what is currently occurring, not on what could potentially occur,[46] and (2) because of the physical presence standard, a business would have to engage in a physical relocation, not just a paper restructuring, and there is no evidence that businesses engage in unworkable restructurings simply to avoid paying state taxes.

B. *NOT A TAX SHELTER VEHICLE*

H.R. 1956 neither encourages the use of abusive tax planning nor nullifies the ability of states to attack such shelters. Under H.R. 1956's physical presence standard, businesses are taxable in a jurisdiction if that business maintains property, including inventory, an office, or other facility, or non-solicitation employees. As a result, to engage in "tax sheltering," a business would have to engage in a physical relocation of its actual business operations to avoid taxes, not just a paper

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[44] It is interesting that critics of proposals that address multistate taxation always counter with claims that the proposal will cause significant revenue loss to the states. *See, e.g., Corporate Tax Sheltering and The Impact On State Corporate Income Tax Revenue Collections,* Multistate Tax Commission (July 25, 2003); Dan Bucks, Elliott Dubin and Ken Beier, *Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act*, Multistate Tax Commission (Sept. 24, 2003); Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, Center on Budget and Policy Priorities (October 20, 2003). Yet there is no reliable empirical evidence that states have actually lost revenue when measures affecting state taxation have been enacted. This certainly goes to the credibility (or lack thereof) of such claims. As an example of the unreliability of such claims, the National Conference of State Legislatures has expressed its concern over projections by some national organizations that the inclusion of telecommunications services in the Internet tax moratorium would cost the states $22 billion each year (an estimate representing the total revenue from all state and local telecommunication taxes in the 50 states from 1992); in a letter to Senator Alexander dated November 5, 2003, the Congressional Budget Office estimated that the actual revenue cost would be between $80 million and $120 million per year starting in 2007 – an estimate that is approximately 220 times smaller. *Accord* Congressional Budget Office Cost Estimate, H.R. 49, Internet Tax Nondiscrimination Act, as requested by the House Comm. on the Judiciary (July 21, 2003). In a November 4, 2003 action alert regarding S. 150, "The Internet Tax Non-Discrimination Act," the NCSL stated that "[t]he $20 billion estimation runs counter to expressed congressional intent and the provisions of the Manager's amendment and as a result threatens to seriously harm the credibility of state governments before Congress and the Administration."

[45] *See, e.g.*, the debunking of the report of the California Franchise Tax Board concerning H.R. 1956. *Response to California Franchise Tax Board Analysis of H.R. 1956: The Federal Business Activity Tax Bill* (provided by the Coalition for Fair and Rational Taxation), 32 State Tax Notes 9, at 697 (May 31, 2004); *See also* Arthur R. Rosen and Karen S. Dean, *Is the Sky* Really *Falling?*, 31 State Tax Notes 381 (Jan. 28, 2004).

[46] During the 107th Congress, the Multistate Tax Commission asserted that H.R. 2526 caused $9 billion of *potential* revenue loss per year. *See, e.g.,* The Internet Tax Fairness Act of 2001: Hearing on H.R. 2526 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary, 107th Cong. (2001) (statements of June Summers Hass, Commissioner of Revenue, Michigan Department of Treasury). However, neither the mere potential to collect tax nor the potential revenue loss resulting from possible tax planning are factors in determining revenue impact; revenue impact is based on the actual amounts that are currently collected.

restructuring, and there is no evidence that businesses engage in unworkable restructurings simply to avoid paying state taxes. In fact, the Congressional Willis Commission studied the impact of the enactment of Public Law 86-272 and concluded that virtually no companies had changed their business methods or structure in order to come within the protections of that statute.[47] At any rate, if any business were to relocate, it would be required to pay taxes to the jurisdiction to which it moved.

Perhaps most important, H.R. 1956 would have **no** effect on the ability of states to attack tax shelters using weapons such as the common law principles of economic substance, alter ego, and non-tax business purpose or statutory remedies such as combined reporting (which is used by many states, including Kansas), I.R.C. § 482-type authority to made adjustments to properly reflect income, statutory addbacks (which are being enacted by an increasing number of states, e.g., Georgia and North Carolina), or similar provisions. These are powerful and straightforward approaches to attacking "bad behavior" that states are using successfully. If a taxpayer does something "tricky" to reduce taxes, it should be attacked "for being tricky" through the use of the myriad tools that the federal, state, and local governments now have and will continue to have.

V. CONCLUSION

The physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy[48] and that is consistent with Public Law 86-272, a time-tested and valid Congressional policy. Physical presence is an accepted standard for determining nexus.[49] 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 benefits or protections to the taxpayer. H.R. 1956 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.[50]

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[47] *See* 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).

[48] 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.

[49] *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).

[50] While it is unrealistic that H.R. 1956 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 forty-six 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.

On the other hand, 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 H.R. 1956 provides the most fair and equitable standard. This is true primarily for two reasons. One, businesses have a reasonable expectation of taxation only when they are the recipients of the benefits and protections provided by the taxing jurisdiction. Two, a physical presence standard protects in-state businesses from "foreign tax" imposed by jurisdictions solely because of the business having customers located in the taxing jurisdiction. By providing clarity, the physical presence standard removes an impediment to investment in the United States. For these reasons, the bill would benefit both U.S. businesses and consumers and, thus, the American economy as a whole.

Unlike other state tax issues currently the subject to debate, at this time, there is no indication that the business activity tax nexus issue will be settled absent Congressional action. The comments herein only scratch the surface of why a physical presence nexus standard for business activity taxes and modernization of Public Law 86-272 is the right answer and why H.R. 1956 should therefore be enacted. But it is clear that H.R. 1956 warrants the full and enthusiastic support of the Subcommittee. H.R. 1956 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,

Arthur R. Rosen
Counsel, Coalition for Rational and Fair Taxation

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PREPARED STATEMENT OF THE COUNCIL ON STATE TAXATION (COST)

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Response to the National Governors Association Estimates of the State and Local Tax Impact of H.R. 1956

October 6, 2005

The National Governors Association (NGA) recently released a report, "Impact of H.R. 1956 Business Activity Tax Simplification Act of 2005 On States" (September 26, 2005), that presents estimates of the impact of H.R. 1956 on state and local business tax collections. The report is based on revenue estimates provided to the Multistate Tax Commission (MTC) by 34 states.[1] A number of shortcomings in the estimating process raise serious questions about the quality of these estimates and thus the reliability of the NGA study itself. These shortcomings include:

- Inconsistent results across the states;
- Misinterpretations of H.R. 1956's provisions;
- Significant differences in estimating methodology;
- Incomplete information to validate the estimates; and
- Estimating procedures that bias the estimates.

As explained in a discussion of these key points, the results presented in the NGA's report do not provide consistent or credible estimates of the expected impact of H.R. 1956. The shortcomings in the study undermine the usefulness of the estimates in the tax policy debate.

About COST

The Council On State Taxation (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 575 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory State and local taxation of multijurisdictional business entities.

[1] The individual state estimates were provided in response to a survey (the "MTC survey") distributed by the Multistate Tax Commission, "Estimating Potential Revenue Impact of H.R. 3220 on State and Local Business Activity Taxes," Guidance and Methodology, May 14, 2004.

Inconsistent Results

The actual results reported in the NGA study clearly show that the states themselves fundamentally disagree on how H.R. 1956 will affect their tax revenues. This disagreement is obvious from the study's results presented for the minimum static impacts (Appendix Table 1A, column 1).[2] Although any piece of legislation is subject to different interpretations by different parties, the range of difference between the states is difficult to explain by way of honest disagreement between neutral observers. Furthermore, because the static estimates provided by the states exclude the more speculative estimates of the dynamic and compliance effects, one would expect closer agreement on these revenue estimates than was the case in the NGA study.

- The published figures show a tremendous variation in the range of estimated revenue impact. Expressed as a percentage of total taxes affected by H.R. 1956 (business activity tax revenue), the static loss among the 29 reporting states ranges from 0.0% for Virginia to 39.7% for Missouri. *These results suggest that H.R. 1956 will have no effect on business tax collections in Virginia, but the same bill will result in a static loss (before any tax planning or restructuring) of almost 40% of Missouri's total business activity taxes.* This tremendous variation between states estimates results from significant differences in interpretation of the bill's provisions; not all of these interpretations can be correct.

- The variation between state results is even more dramatic when the dynamic and compliance effects are included. Although somewhat greater variation is understandable given the fact that the concepts ("dynamic" and "compliance" effects) themselves were not clearly defined in the Multistate Tax Commission's (MTC) survey instructions, the variation reported in the survey is extraordinarily wide. *With all three effects—static, dynamic and compliance—included, the estimated loss as a percent of the business activity tax revenue ranges from 0 to 64%.* In other words, some states estimate that H.R. 1956 will have almost no impact on their state's revenue while others estimate that it will result in a significant revenue decrease. As noted previously, the wide range of responses suggests that many of the estimates are far wide of the true mark.

- The large differences among the estimates cannot be explained by variations in state economies or business tax structures. For example, of the states that utilize combined reporting, five states estimated a total tax loss of 2% or less, but three states estimated losses of more than 20%. For another example of the lack of consistency among states, four states report dynamic effects 10 times or more than the static effects, while eight states report dynamic effects less than the static effect.

- As a minor point, there is also an inconsistency in the NGA's estimate of total business activity taxes that may be affected by the H.R. 1956. In the introduction (p. 4), the NGA report states that total business activity taxes were $89.8 billion in 2004. This figure is significantly higher than the estimated fiscal year 2007 business activity tax total of $57.7 billion (Table 3, p. 20) based on estimates from the states. There is no explanation for this inconsistency.

[2] The MTC survey asked states to provide minimum, best and maximum impact estimates for three different components of the impacts: static, dynamic, and compliance effects. Only 7 out of the 34 states were able to provide estimates for the compliance effect impact.

More fundamentally, as discussed in the next section, this variation in state responses to the MTC survey upon which the NGA study was based represents a basic disagreement or misunderstanding over the expected impact of the bill and/or dramatically different revenue estimating methodologies that are not explained in the report. It would be very helpful to know what explains those differences, both to ensure the accuracy of the overall revenue estimate, and to understand how differences in states' tax laws and the expectations of taxpayer responses to the bill could produce such dramatic state-by-state differences.

Given the obvious uncertainty within the states about the effects of H.R. 1956, it is disappointing that the NGA did not use the survey information and contacts with state revenue departments to ensure greater consistency of the revenue analysis across states. The state revenue estimators were obviously not using the same concept of behavioral change (or other impacts) in analyzing the bill. Because, in effect, they were analyzing different interpretations of the bill and its impacts, it is not clear how the state estimates can be used to understand the impact of H.R. 1956.

Lack of Understanding of the Bill's Impact[3]

The fact that the states do not agree on the interpretation of the provisions of H.R. 1956 or on taxpayer's likely behavioral response to the legislation is also clear from public analyses of the expected impact of the bill published by individual states. For example, California and Kansas differ substantially in their descriptions of the bill's expected impacts on their corporate income tax systems.

Both California and Kansas require companies that are unitary in operation to combine their incomes in determining their state corporate income taxes. Each taxpayer then apportions the combined income to the state based on the taxpayer's in-state share of the combined group's payroll, property and sales. California's analysis of the bill's impact[4] correctly points out that the federal legislation would not restrict the state's ability to require combined unitary filing for a unitary group (although it may affect the percentage of the combined income attributable to the state).

In sharp contrast, the Kansas analysis of H.R. 1956 implies that the bill could prevent the state from applying the unitary business principle. The analysis states: "If this [the assertion that the bill limits the unitary principle] is correct under H.R. 1956, then multi-state business enterprises could re-structure themselves to fit into one of more of the safe harbors and avoid the application of the unitary business principle. Their tax liability would be determined under separate accounting principles."[5] In fact, however, H.R. 1956 would not have any effect on a state's ability to require combined unitary filing. (The U.S. Supreme Court has condoned including entities that are not themselves subject to tax in the combined tax return.)

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[3] This section is generally limited to the states' differences of opinion regarding the impact of H.R. 1956. A more thorough discussion of this issue would include an analysis of the MTC's seriously flawed interpretations of the effect that H.R. 1956 would have on existing case law. The legal assumptions contained within the MTC's survey undoubtedly introduced further and significant bias into the revenue estimating process.
[4] California Franchise Tax Board, "Federal Business Activity Tax Proposal HR 3220," December 11, 2003. As pointed out in the NGA report (footnote 1, p. 1), the initial revenue estimate of the impact of the federal legislation was actually based on the provisions of H.R. 3220. The California analysis was also based on H.R. 3220.
[5] Kansas Department of Revenue, "Kansas Fiscal Impact Estimate of H.R. 1956," September 27, 2005, p.1.

This misunderstanding appears to have resulted in overstated losses from H.R. 1956 in Kansas. According to Appendix Table 1B, the states' best estimate of the total loss as a percent of business activity taxes, is 2 percent in California and 28.8 percent in Kansas. However, the NGA report includes another estimate of the same number for Kansas, 10.9 percent, in Table 3. It is not clear why the NGA report has two different numbers for Kansas.[6] In any case, one cannot expect consistent estimates of the bill's impact across states if states differ so significantly in their view of the fundamental impacts of the bill.

It appears that the MTC survey may have also contributed to this confusion. In a footnote in the glossary section of the survey instructions, the MTC provides examples of how firms might set up in-state affiliates to provide certain services and lead to the result, that while the affiliate has nexus in the state, "the rest of the business or corporate structure would be exempt [from taxation]."[7] This interpretation is, of course, inapplicable to unitary combined reporting states as the net income of the unitary group would still include the income of all the companies in the group, although the apportionment factors may be reduced under the bill.

Incomplete Information

Although the NGA report includes a lengthy discussion of the possible impact of H.R. 1956 and a number of tables showing a wide range of tax losses, it contains little information on the actual estimating methodology. For this reason, it is not possible to judge the reasonableness of the estimates provided by the states. In other words, there is little explanation of how the states actually translated the anecdotal examples of revenue losses for a single firm—provided in the survey—into actual dollar losses for all of the state's business taxpayers.

It would be useful to have more information about the revenue estimates, such as:

- The states' estimates of the effect of H.R. 1956 by type of tax;
- The business activity taxes included in the states' analysis (For example, did the study include the New Mexico gross receipts tax, which has been recognized by state and federal courts as a transaction tax and thus not subject to the provisions of H.R. 1956?);
- The current thresholds for nexus used by the states (For example, did the states use a minimal dollar amount of payroll and property or a minimum percentage threshold? States were asked to provide this information, but it does not appear in the report.);
- How the states determined minimum, maximum and best point estimates; and
- How states differentiated between static and behavioral tax impacts.

The NGA should provide this information, which is critical in evaluating the validity of the report's results and which would be helpful for policy makers and analysts in understanding the size and composition of the revenue effects of H.R. 1956. More generally, the state-by-state estimates of the impact of H.R. 1956 should be subject to the same level of public scrutiny as any other bill analysis that a state revenue department would prepare for a tax bill. The additional information collected in the surveys and other feedback from the states should be made public to help policy makers understand these major differences between the state estimates and to reach a clear consensus on the likely tax effects of the bill.

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[6] The 10.9 percent figure seems more in line with the numbers included in the Kansas Department of Revenue September 27, 2005 public report on the estimated impact of H.R. 1956. It appears that the Kansas estimates of both the tax loss and business activity taxes are different in the two NGA report tables.

[7] Multistate Tax Commission, "Estimating Potential Revenue Impact of H.R. 3220 on State and Local Business Activity Taxes," Guidance and Methodology, May 14, 2004, p. 9.

Biased Estimates

Even if the revenue estimators for the NGA study agreed—which they clearly do not—on the proper interpretation of the bill's provisions and the probable behavioral responses of taxpayers, the NGA's estimating process produced estimates that significantly overstate the revenue loss. The MTC survey explicitly instructed state revenue departments to use assumptions about the effects of H.R. 1956 that bias the estimate of the potential revenue impact upward. This bias is true both for the static impact estimates as well as the more speculative dynamic and compliance estimates. For example:

- The MTC survey asked state revenue departments to "assume that those businesses that are currently remitting business activity taxes but have $0 *or de minimis* amounts of either property or payroll would not be subject to your states business activity taxes."[8] Companies currently paying business activity taxes with "small" (de minimis) amounts of payroll or property are complying with current law thresholds for nexus. This MTC survey assumption is glaringly invalid because it is not the case that all such firms would automatically stop paying these taxes if H.R. 1956 is enacted.

  If state revenue estimators actually eliminated taxes for all firms that had no or minimal payroll *or* property factors, they could be significantly overstating the potential revenue impact of H.R. 1956. A firm with no in-state property (or no payroll) may still have substantial amounts of the other factor that establishes nexus. For example, there are a number of state corporate income tax payers in each state with no property value in a state but payroll amounts that exceed several million dollars. For firms with this level of employees in a state, the change, for example, to a 22 day minimum threshold is highly unlikely to eliminate nexus and these firms should not be included in the revenue loss estimate.

  Again, the MTC survey instructions asked states to report the de minimis level of the payroll and property factors. It would be useful to know what those de minimis levels were, by industry, and how they differ across states. Use of percentage thresholds for factors, for example, could significantly overstate revenue losses. A 0.01% property threshold for a large company, say $10 billion of property nationally, would result in $1 million of property in the state. This may be a very small fraction, but it is not a de minimis amount of in-state property. It is not reasonable to assume that this company would no longer have nexus in the state as soon as the bill is passed.

- It is not clear that the state revenue estimates included the positive impacts on state business taxes that would result from H.R. 1956. (The request from the MTC tellingly only asks about the revenue *lost* from the bill). For example, states with throwback rules should experience increased revenues if in-state firms have higher sales in states where they no longer have nexus. This will create a "windfall" of additional revenues in the throwback states that have more income apportioned to their state. While it may have been difficult for any one state to estimate this positive impact, the NGA should have included at least an aggregate estimate of this revenue increase.

  As another example, it does not appear that estimators added in the additional revenues that would be created by the assumed additional business activities of in-state contractors and affiliates. The NGA report stresses the use of independent contractors as a possible behavioral change that reduces taxes. But, if a company switches to using in-state independent contractors rather than its

[8] Multistate Tax Commission, p. 4.

own employees, then the independent contractors will have higher in-state receipts and income. This will naturally result in higher tax payments from those independent contractors, and those payments will partially offset the losses from other behavioral changes. If state estimators ignored this positive offset, the revenue losses in the NGA report are biased upward.

- The MTC instructions for estimating the "compliance" effects of H.R. 1956 are clearly biased toward higher impact estimates. The estimators were instructed to estimate any new dollars expected to be collected from current compliance activities that are not in current tax collections. In fact, current tax collections always include a compliance component. Because estimators do not know the size and composition of the current compliance dollars, they cannot estimate the "new" compliance amounts that could be precluded by the bill. In addition, given the on-going controversy over current nexus standards, it is just as likely that current tax collections contain compliance amounts that will have to be refunded to taxpayers because of court decisions favorable to taxpayers; these amounts should be subtracted from the baseline. Because of these estimating difficulties, the compliance estimates should not have been included at all.

- The estimates of tax losses may include revenue from taxes that are not affected by the bill or are expected to have little revenue impact due to the inability of firms to reduce physical presence in a state. Examples reported in the footnotes of the appendix tables in the NGA report include excise taxes that may be considered transaction taxes—which are not affected by the bill—and gross receipts taxes on specific industries, such as cigarette wholesalers, banks and public utilities—most taxpayers in these industries will have a significant physical presence in a state and thus those taxes are unlikely to be affected by the legislation. To avoid overstating the revenue losses for these specialized industry taxes, the revenue estimates should have been done on an industry-by-industry basis; if they were not, the revenue losses may be overstated.

Conclusion

Credible estimates of the impact of federal legislation on state tax systems are critical to the full and fair debate of such legislation. Unfortunately, the recently released NGA study of H.R. 1956 is simply not credible. As discussed in this paper, the NGA study includes numerous shortcomings that seriously undermine its usefulness in the debate over H.R. 1956. Given their membership, the NGA and the MTC are in a unique position to provide meaningful data regarding the fiscal impact on the states of proposed federal legislation. In the case of H.R. 1956, however, the NGA and the MTC have widely missed the mark.

In an effort to enhance the public policy debate on H.R. 1956 and similar measures which are of critical import to both states and the business community, COST stands willing to work the NGA and the MTC prior to the release of any future revenue estimates.

CRS REPORT ENTITLED "STATE CORPORATE INCOME TAXES: A DESCRIPTION AND ANALYSIS," UPDATED MAY 11, 2005, STEVEN MAGUIRE, ANALYST IN PUBLIC FINANCE, GOVERNMENT AND FINANCE DIVISION, SUBMITTED BY THE HONORABLE WILLIAM D. DELAHUNT

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State Corporate Income Taxes: A Description and Analysis

Updated May 11, 2005

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State Corporate Income Taxes: A Description and Analysis

Summary

Recently, state corporate income taxes have become the subject of renewed interest to both state and federal policymakers. The cause of this elevated interest may be the gradual decline in revenue generated by the tax, the expansion of electronic commerce, and/or federal tax policy that affects state corporate income taxes. Congress has had a role in state corporate income taxes for at least two reasons: (1) interstate commerce regulatory oversight and (2) federal and state corporate income tax interaction. Congress may become more involved in state corporate tax issues because of recent changes in interstate commerce and how states administer corporate taxes.

The state corporate income tax is not a major source of revenue for states, but is still an important contributor to state finances. Over the last decade, state corporate income taxes generated approximately 5% of state tax revenue. However, the revenue generated by the tax — measured as a percentage of gross domestic product — has been gradually declining. Several explanations have been offered for this gradual decline including (1) state policy decisions to lower the tax burden on corporations; (2) aggressive tax planning by corporations; (3) broad economic cycles diminishing the base; and (4) federal corporate income tax policy. Most research has identified the first two factors as the primary cause for the recent decline.

Many corporations operate in multiple tax jurisdictions which makes the state corporate income tax a relatively complex tax to administer. The base of the corporate income tax (net income or profits) must be fairly apportioned to all of the states where the firm has established a presence (or nexus). A mosaic of nexus standards has been created through multistate tax compacts, state and federal legal decisions, and congressional actions. At present, states do not use a uniform definition of taxable profits or use a uniform method of apportioning income.

Legislation was introduced in the 108th Congress that would have addressed some of the issues identified above. Nexus issues were addressed in what was identified as "streamlining" legislation. Generally, the streamlining legislation would have allowed states to require out-of-state vendors to collect sales and use taxes even if the out-of-state vendor does not have nexus in the taxing state. Participating states would have to simplify sales and use taxes before Congress would confer collection enforcement authority. Interstate commerce has complicated the nexus issue for sales and use tax administration and how this issue is resolved may have broader implications for state corporate income taxes.

Legislation has been introduced in the 109th congress, H.R. 1956, that addresses nexus issues for state corporate income taxes directly, sometimes identified as "brightline" legislation. This legislation would establish more uniform standards — generally higher standards — for the level of business activity that would trigger nexus and thus corporate income taxability. This report will be updated as legislative events warrant.

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State Corporate Income Taxes: A Description and Analysis

Congressional interest in state corporate income taxes arises from two distinct issues. First, Congress has a direct role in the oversight and regulation of interstate economic activity. State taxation of multi-state corporations would certainly be included in this jurisdiction. Second, federal corporate income tax policy changes have a direct effect on state (and local) tax structure.[1] Congressional activity, or in some cases inactivity, in these two areas can have a pronounced effect on state budget decisions. After an overview of state corporate income taxes, this report analyzes both the interstate commerce oversight and tax interaction issues. The last section of the report describes and analyzes past legislation that would have affected state corporate income taxes. Legislation in the 109th Congress will likely be modeled after earlier legislation.

State Corporate Income Taxes: Overview

For most observers, state corporate income taxes are the most familiar state tax that businesses pay. However, corporate income taxes generated less than 5.2% of total state tax revenue in 2003. In contrast, general sales and use taxes, of which businesses pay a large portion, accounted for approximately 33.3% of state tax revenue.[2] Even though state corporate income taxes represent a relatively small portion of total state tax revenue in most states, the state corporate income tax still generated $28.5 billion in 2003. And, in some states, the corporate income tax contributes a much larger share of total tax revenue. For example, from 1972 to 2003, the corporate income tax averaged approximately 19.8% of total state tax revenue in New Hampshire. In contrast, the corporate income tax contributed 3.7% of total tax revenue in South Dakota.[3]

As New Hampshire and South Dakota show, the dependence on corporate income taxes varies considerably from state to state; thus, federal corporate income

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[1] State taxation of international firms and individuals is also of interest to Congress. International tax policy, however, extends beyond the scope of this report.

[2] Data are CRS calculations based on U.S. Census of Governments data. These data is available at the following website: [http://www.census.gov/govs/www/statetax03.html]. Robert Cline, Tom Neubig, Andrew Phillips, and William Fox, "Total State and Local Business Taxes: Nationally 1980-2004 and by State 2000-2004," *State Tax Notes*, May 9, 2005, estimated that businesses paid approximately 43% of total state and local taxes. A separate estimate of the portion of total sales tax revenue collected from businesses was not provided.

[3] CRS calculations based on U.S. Census of Governments data; see above for website link.

tax policy does not have a uniform effect on all states. The remainder of this section describes the mechanics behind state corporate income taxes, highlighting the differences among states. Understanding the nuances of state corporate income taxes is necessary for a complete discussion and analysis of interstate commerce issues and the link between federal and state tax policy.

The Mechanics of the State Corporate Income Tax

Generally, the state corporate income tax is levied on the accounting profits of a corporation.[4] The portion of profit that can be attributed to a state serves as the base for that state's corporate income tax. Profits are allocated to a state based on the amount of economic activity that occurs in that state. Following is a more detailed description of the state corporate income tax structure.

Federal Starting Point. Most states and the District of Columbia incorporate the federal income tax code as currently amended (20 states) or as of a specific date (17 states).[5] The remaining states typically use a measure of income that closely follows the federal definition of taxable income. Using the federal starting point likely eases the compliance burden for corporations, particularly those that have nexus in several states. Nevertheless, many states still require corporations to "add-back" to income exclusions that are allowed under federal corporate income tax rules.[6]

The Uniform Division of Income for Tax Purposes Act (UDITPA). The Uniform Division of Income for Tax Purposes Act (UDITPA) is a model act drafted and adopted by the Commissioners on Uniform State Laws and the American Bar Association. The Act sets standards for separating income into business income, which is apportioned to states, and non-business income, which is allocated entirely to the entity's home state. Generally, non-business income is defined as passive income on corporate owned assets; income from these assets could include dividends, rents, and royalties. Corporations could avoid paying taxes on non-business income by locating in states without a corporate income tax.[7] Some states, through the Multistate Tax Compact (MTC), have voluntarily adopted uniform rules and procedures for the allocation and apportionment of income — as defined under UDITPA — to ease the compliance burden on multistate businesses.[8] Many of the

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[4] Net income is revenue less expenses, which is roughly equivalent to pre-tax accounting profits.

[5] These 37 states directly incorporate the federal tax code, however, all states except for Arkansas and Mississippi, use federal income for the starting point for purposes of calculating income tax liability.

[6] Bureau of National Affairs, "Multistate Tax Report: 2003 Survey of State Tax Departments," vol. 10, no. 4, April 25, 2003. The report identifies the add-backs and other special corporate income tax rules for each state.

[7] A "throwback" or unitary accounting rules would limit this type of tax planning to avoid taxation of non-business income.

[8] According to the Commerce Clearing House (CCH) publication, State Corporate Income

(continued...)

states that have not formally adopted UDITPA standards still closely adhere to the UDITPA standards.

The Profit Apportionment Formula. Typically, three factors of economic activity are used in the apportionment formula to measure the economic presence of a firm in a state: the percentage of property, the percentage of sales, and the percentage of payroll. Not all states weigh factors equally; some over-weight sales or use only sales to allocate income (often called single-factor sales apportionment). In theory, the weighting should accurately portray the economic presence of the firm. There is no consensus on the definition of "economic presence," and hence there is variation among state apportionment formulas.

Some analysts have suggested that a formula that double-weights sales is the ideal formula because it gives equal weight to input factors (property and payroll), and an output factor (sales).[9] Others have argued that the business tax should be levied based on the business's use of government services provided by the firm's resident state. For example, a corporate income tax that is levied according to the value of one input only, such as property, could be justified because the value of property is closely related to the level of government services provided to the business by the home state. However, corporations also receive benefits from an out-of-state customer's well functioning legal system and public infrastructure. An apportionment formula that includes just the property factor would not compensate the out-of-state customer's government for the benefit to the corporation of those public services.

The general form of the apportionment formula is reproduced below. The superscript i represents the profits (π), sales (s), property (p), and labor (l), a state attributes to the i-th firm. The superscript T represents the total value of each factor and profits for the firm in a given tax year. The subscript w represents the weight of each respective factor as defined by state law; the weights sum to one.

$$\pi^i = \pi^T \times \left[\left(\frac{s^i}{s^T} \right) \times w_s + \left(\frac{p^i}{p^T} \right) \times w_p + \left(\frac{l^i}{l^T} \right) \times w_l \right]$$

For example, states that use an even-weight formula would use 0.33 for each w, meaning each factor contributes equally to the determination of profits attributable to a state. If the state were to "double-weight" sales, that means that the w_s is twice the amount of each of the other two weights. In the case of double-weight sales, w_s=0.50; w_p=0.25; and w_l=0.25.

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[8] (...continued)
Tax Guide, seven states have enacted UDITPA as written and 12 more states have adopted UDITPA with some minor modifications.

[9] James Francis and Brian H. McGavin, "Market Versus Production States: An Economic Analysis of Apportionment Principles," in *State Taxation of Business: Issues and Policy Options*, Thomas Pogue, ed. (New York: Praeger Publishers, 1992), p. 61.

Nexus. The apportionment formula does not imply that a business that sells goods and services into a state, owes taxes to that state. A state can levy a corporate income tax on a business only if the business maintains a substantial nexus in the state. The nexus rules governing the corporate income tax were partially circumscribed by Congress through P.L. 86-272, (the Act). The Act established that the mere solicitation of the sale of *tangible* goods by a firm in a state was not substantial nexus for corporate income tax purposes. However, for intangible goods and services, there is significant variation from state to state in how physical presence is defined.

The Bureau of National Affairs periodically surveys state revenue departments about activities that could create nexus.[10] The responses highlight the differential treatment from state-to-state of business activities deemed to create nexus. For example, according to the report, 24 states reported that an out-of-state corporation that reimbursed its in-state salespersons had established nexus whereas 19 states reported that activity would not. Establishing a web server in a state created nexus in 16 states whereas 23 states did not indicate that maintaining a web server would establish nexus.

Throwback Rule. Because of the state-by-state variation in nexus rules, the first step for corporations before apportioning income is to determine the states where the firm has established nexus. The firm then allocates profits to these states based on each respective state's apportionment formula. The different state apportionment formulas and nexus rules, however, often lead to what is termed "nowhere income."[11] Nowhere income arises because not all states have the same apportionment formula and some states do not levy a corporate income tax. For this reason, some states impose corporate income tax rules that stipulate that all sales to customers in states that do not tax the sales (through a corporate income tax) are "thrown back" to the home state.

For example, a California firm that sells goods to customers in Nevada — which does not have a corporate income tax — would include Nevada sales in the numerator of the sales factor component of the California apportionment formula. If Nevada had a corporate income tax with a sales factor in the apportionment formula, California would not require the firm to include the Nevada sales in the California corporate income tax apportionment formula. The throwback rule is applied in 24 states and the District of Columbia; 22 states do not impose a throwback rule; and four states do not impose a corporate income tax (see **Table 1**).[12]

State Apportionment Formulas. **Table 1** groups states based on their corporate income tax apportionment formula. "Even-weight" implies that the each

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[10] Bureau of National Affairs, "Multistate Tax Report: 2003 Survey of State Tax Departments," vol. 10, no. 4, April 25, 2003.

[11] The converse is also true. Income could also be *overtaxed* because of the variety of apportionment formulas employed by states.

[12] Commerce Clearing House, *Multistate Corporate Income Tax Guide*. Texas imposes a gross receipts tax that operates as a corporate income tax although it is not technically a corporate income tax. Texas uses a throwback rule for the gross receipts tax.

factor is weighted the same or one-third. The hybrid arrangements allow firms to choose the type of apportionment scheme that minimizes tax burden or instructs the firm to use different types of allocation based on the source of income. The most common apportionment formula is the double weighted sales scheme.

Table 1. State Corporate Income Tax Apportionment Formulas

Apportionment Scheme (number of states)	States
Even-weight (11)	Alabama, Alaska, Delaware, District of Columbia, Hawaii, Kansas, Montana, North Dakota, Rhode Island, Utah, and Vermont.
Even-weight hybrid (3)	Missouri, firms choose either even weight or single factor sales; New Mexico, certain manufacturing firms can choose double-weight sales, otherwise even-weight; Oklahoma, firms meeting certain investment criteria can choose double-weight sales, otherwise even-weight.
Double-weight sales (19)	Arizona, Arkansas, California, Florida, Georgia, Idaho, Indiana, Kentucky, Louisiana, Maine, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Tennessee, Virginia, West Virginia, Wisconsin.
Double-weight sales hybrid (3)	Connecticut, double-weight sales for income derived from the sale or use of tangible personal or real property, single-factor sales for other income; Maryland, manufacturers use single-factor sales, otherwise double-weight sales; South Carolina, double-weight sales for manufacturers and dealers in tangible personal property, otherwise single-factor sales.
Single-factor sales (3)	Illinois, Iowa, and Nebraska.
Other weight allocations (5)	(in percentages, sales- payroll-property) Michigan, 90-5-5; Minnesota, 75-12.5-12.5; Ohio, 60-20-20; Oregon, 80-10-10; and Pennsylvania, 60-20-20.
Other hybrids (2)	Colorado, firms choose between a three-factor even-weight and a two-factor (sales and property) even-weight; Mississippi, retailers, wholesalers, service companies, lessors use single-factor sales, wholesale manufacturers use even-weight three factor, retail manufacturers use three-factor, double-weighted sales.
No general corporate net income tax (5)	Nevada, South Dakota (bank & financial corporation excise tax), Texas (gross receipts tax), Washington, and Wyoming.

Source: Commerce Clearing House, Multistate Corporate Income Tax Guide.

State Corporate Income Tax Rates. Rates on corporate income taxes vary considerably. The state with highest rate, Iowa, taxes all taxable income in excess of $250,000 at 12%. Iowa is also one of three states (Nebraska and Illinois being the others) that use a single-factor sales apportionment formula. The rates for each state are listed on the following page in **Table 2**. The highest marginal rates listed in **Table 2** do not necessarily represent the relative burden of state corporate income

taxes in each state. The best measure of the relative corporate income tax burden for each state is the *average effective* marginal tax rate (AEMTR). The AEMTR would incorporate differences among states in the definition of taxable income. Nevertheless, the marginal rates do provide some information about the relative burden of corporate income taxes across states.

Table 2. State Corporate Income Tax Rates, 2005

State	Highest Rate	Number of Rates	State	Highest Rate	Number of Rates
Alabama	6.500%	one	Montana	6.750%	one
Alaska	9.400%	multiple	Nebraska	7.810%	multiple
Arizona	6.968%	one	Nevada	no tax	n/a
Arkansas	6.500%	multiple	New Hampshire	8.500%	one
California	8.840%	one	New Jersey	9.000%	multiple
Colorado	4.630%	one	New Mexico	7.600%	multiple
Connecticut	7.500%	one	New York	7.500%	one
Delaware	8.700%	one	North Carolina	6.900%	one
D.C.[a]	9.975%	one	North Dakota	10.500%	multiple
Florida	5.500%	one	Ohio[e]	8.500%	multiple
Georgia	6.000%	one	Oklahoma	6.000%	one
Hawaii	6.400%	multiple	Oregon	6.600%	one
Idaho	7.600%	one	Pennsylvania	9.990%	one
Illinois[b]	4.800%	one	Rhode Island	9.000%	one
Indiana	8.500%	one	South Carolina	5.000%	one
Iowa	12.000%	multiple	South Dakota[f]	6.000%	multiple
Kansas	4.000%	one	Tennessee	6.500%	one
Kentucky	8.250%	multiple	Texas[g]	4.500%	one
Louisiana	8.000%	multiple	Utah	5.000%	one
Maine	8.930%	multiple	Vermont	9.750%	multiple
Maryland	7.000%	one	Virginia	6.000%	one
Massachusetts[c]	9.500%	one	Washington	no tax	n/a
Michigan	1.900%	one	West Virginia	9.000%	one
Minnesota[d]	9.800%	one	Wisconsin	7.900%	one
Mississippi	5.000%	multiple	Wyoming	no tax	n/a
Missouri	6.250%	one			

Source: Commerce Clearing House, Multistate Corporate Income Tax Guide.

[a] The D.C. rate is new beginning with the 2004 tax year.
[b] S Corporations, partnerships, and trusts are taxed at a maximum 6.3% rate.
[c] Financial institution net income is taxed at 10.5%. Corporations also pay a surtax on property located in Massachusetts and not taxed at the local level.
[d] Minnesota also levies a fee based on the total payroll, property, and sales of the corporation. The fee raises the maximum tax rate and creates very slight progressivity.
[e] Ohio allows firms to choose an alternative of four mills (or 0.4%) multiplied by taxable net worth.

[7] South Dakota taxes only banks and financial institutions. The rates fall as net income rises from a high of 6.0% for the first $400 million to 0.25% for the amount over $1.2 billion.
[8] Texas taxes "net taxable earned surplus" and adds a surtax of 0.25% on net taxable capital.

State Corporate Income Tax Revenue: 1972 to 2003

According to CRS calculations based on data from the U.S. Census Bureau, state tax revenue from state corporate income taxes grew most fiscal years with the exception of 1982, 1983, 1992, 1993, 1999, 2001, and 2002. However, as a portion of gross domestic product (GDP), corporate tax revenue has declined from an annual average of 0.43% of GDP over the FY1972 to FY1981 time frame to 0.33% of GDP over the FY1994 to FY2003 time frame. **Table 3** reports state corporate tax revenue and GDP for states that impose a state corporate income tax.[13]

Table 3. State Corporate Income Tax Revenue and Gross Domestic Product, FY1972 to FY2003

Fiscal Year	State Corporate Tax Revenue (in billions)	State Corporate Tax Revenue as Percentage of GDP	Fiscal Year	State Corporate Tax Revenue (in billions)	State Corporate Tax Revenue as Percentage of GDP
1972	$4.4	0.36%	1988	$21.6	0.42%
1973	$5.4	0.39%	1989	$23.9	0.44%
1974	$6.0	0.40%	1990	$21.8	0.37%
1975	$6.6	0.41%	1991	$20.4	0.34%
1976	$7.3	0.40%	1992	$21.9	0.34%
1977	$9.2	0.45%	1993	$24.2	0.36%
1978	$10.7	0.47%	1994	$25.5	0.36%
1979	$12.1	0.47%	1995	$29.1	0.39%
1980	$13.3	0.48%	1996	$29.3	0.38%
1981	$14.1	0.45%	1997	$30.7	0.37%
1982	$14.0	0.43%	1998	$31.1	0.36%
1983	$13.2	0.37%	1999	$30.8	0.33%
1984	$15.5	0.39%	2000	$32.5	0.33%
1985	$17.6	0.42%	2001	$31.7	0.31%
1986	$18.4	0.41%	2002	$25.9	0.24%
1987	$20.5	0.43%	2003	$28.5	0.26%

Source: CRS calculations based on U.S. Bureau of Census, Governments Division and Bureau of Economic Analysis.

[13] The governments division of the Bureau of Census collects and reports state tax collections by type of tax based on survey information from the states.

Several causes have been suggested for the relatively decline in state corporate tax revenues in FY2001 and FY2002.[14] The most direct causes would be legislated changes in the tax rate, the tax base, or the compliance rules. The decline in revenue could be the result of state governments, in the aggregate, attempting to lower the tax burden on corporations. The December 2003 Fiscal Survey of States reported that states, in the aggregate, enacted net tax cuts every year from FY1995 through FY2001.[15] Even though these tax cuts were not separated into types of tax by the Fiscal Survey, it seems likely that state corporate income taxes were included in the tax cuts. Recent research has reached a similar conclusion, noting that "[S]tate tax bases have deteriorated further than the federal base because of a combination of **explicit state actions** [emphasis added] and tax avoidance/evasion by businesses."[16]

A second explanation, alluded to above, is that corporations are more effectively avoiding, or even evading taxes through aggressive tax planning.[17] The Multistate Tax Commission (MTC) concluded in a recent study that "...various corporations are increasingly taking advantage of structural weakness and loopholes in the state corporate tax systems."[18] Again, the MTC study cannot definitively separate the revenue declines arising from policy changes and avoidance/evasion, but still concludes that tax avoidance and evasion is partly responsible for the decline in state corporate tax revenues.

A third explanation is that cyclical economic changes have led to the decline in state corporate tax revenues. Note that cyclical economic effects are unrelated to the behavior of policymakers or corporations. The effect of economic cycles on revenue is difficult to identify because the legislated changes and the corporate behavior described above likely exacerbated (or attenuated) the cyclical economic changes. Recent research into the causes of state budget deficits, suggested that "the current [cumulative state] deficit is largely structural. ..."[19] The implication of this finding is that policy (structural) changes like tax cuts and discretionary spending increases generated state budget deficits in FY2002 and FY2003, not the machinations of the economic cycle.

Finally, changes to the federal corporate income tax code, which have reduced the base of most state corporate income tax systems, could explain part of the decline in state corporate income tax revenue. A recent report, however, noted that "nearly two-thirds [of states] refused to go along with President Bush's 2001-2004 'bonus

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[14] William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal*, vol. LV, no. 3, Sept. 2002, pp. 491-508.

[15] National Association of State Budget Officers, December 2003 Fiscal Survey of States.

[16] Fox and Luna, 2002, p. 498.

[17] Tax avoidance is a legal means of reducing tax liability, such as buying tax-exempt bonds. In contrast, tax evasion is illegal, such as not claiming otherwise taxable income.

[18] Multistate Tax Commission, "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections," July 15, 2003, from the *Executive Summary*.

[19] Brian Knight, Andrea Kusko, and Laura Rubin, "Problems and Prospects for State and Local Governments," paper presented at Urban Institute Seminar, State Fiscal Crises: Causes, Consequences, and Solutions, April 5, 2003.

depreciation.' ...."[20] The next section discusses the interaction between federal and state corporate income taxes in more detail.

Issues for Congress

State corporate income taxes are of interest to Congress for primarily two reasons: interstate commerce oversight and tax interaction. The following section analyzes these two aspects of state corporate income taxation that are most directly affected by congressional action.

Interstate Commerce Regulation and Oversight

The interstate commerce regulation and tax interaction issues have attracted interest for three principal reasons: (1) the complex Internet sales tax debate; (2) the recent federal business tax cuts; and (3) state fiscal issues. The link between the Internet sales tax debate and state corporate income taxes is complicated and centers on the prohibition on states reaching beyond their borders to compel out-of-state vendors to collect sales and use taxes.[21] As a general rule, a state can require a vendor to collect sales and use taxes only if the vendor has "substantial nexus" in the state.[22] Typically, the substantial nexus standard is satisfied if the vendor has a physical presence in the state.[23] Thus, remote Internet transactions, where the vendor has no physical presence in the customer's home state, do not have the sales and use tax added to the price of the good by the vendor. These types of transactions have grown considerably over the last several years and have contributed to the erosion of the sales and use tax base of most states.[24]

In an effort to persuade Congress to allow states to compel remote vendors to collect use taxes, a coalition of states has been working together to establish a uniform sales and use tax agreement. The coalition of states identify this effort as the "Streamlined Sales and Use Tax Project." States that sign onto the sales tax compact would have already implemented uniform definitions and compliance rules, thus easing the administrative burden of remote vendor collection. Two bills in the 108th

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[20] McIntyre, Robert S and T.D. Coo Nguyen, "State Corporate Income Taxes 2001-2003," *State Tax Notes*, March 7, 2005, pp. 685-712.

[21] A *sales* tax is levied at the time of transaction and is tax on the sale. The companion *use* tax is a tax on the *use* of a good or service. Technically, remote vendors would collect a use tax because the product is going to be used in the customer's home state.

[22] The limitation arises from the due process and commerce clauses in the U.S. Constitution.

[23] For more on the sales tax issue, see CRS Report RL31252, *Internet Commerce and State Sales and Use Taxes*, by Steve Maguire.

[24] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," *Center for Business and Economic Research*, University of Tennessee, September 2001. Bruce and Fox estimated this erosion from electronic commerce alone will result in states losing approximately $24.2 billion in 2006 and $29.2 billion in 2011. There is considerable debate, however, about the size of the revenue loss.

Congress would have granted states these rights.[25] If these bills were enacted and the states satisfied the requirements for qualification, remote vendors in the compact states would collect use taxes for shipments to states where the vendor does not have a substantial nexus.

Some vendors are concerned that collecting use taxes for a state in which they do not have nexus, could trigger income or other business tax liability. However, past court decisions and the landmark P.L. 86-272 established physical presence as the standard for sufficient nexus for corporate income taxes for firms selling tangible goods. The law, P.L. 86-272, was passed shortly after the Supreme Court issued a ruling that seemed to offer an ambiguous definition of "sufficient nexus." The Supreme Court language that generated this concern (as cited in the Senate report on S. 2524, the Senate version of the eventual P.L. 86-272) is reproduced below:

> We conclude that the net income from the interstate operations of a foreign corporation may be subjected to State taxation provided the levy is not discriminatory and is properly apportioned to *local activities within the taxing State forming sufficient nexus to support the same.* [Emphasis added] (358 U.S. 450 at 452)[26]

The term "local activities" was deemed too ambiguous by policy makers and businesses. The Senate report provided the following as reasoning behind the enacted legislation (P.L. 86-272) that clarified the definition:

> Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient "nexus," that is, connection, with the State to support the imposition of a tax on net income from interstate operations and "properly apportioned" to the State.[27]

The legislation passed by Congress clarified nexus by identifying those activities which would *not* establish nexus. Generally, soliciting sales of tangible goods in a state for shipment by common carrier from locations outside the state into the state, would not be sufficient to trigger nexus. Thus, for tangible goods shipped across state lines, state net corporate income taxes are levied at the *source* not the *destination* of the product. The home state of the customer receiving the goods cannot levy a state corporate income tax on the remote business by virtue of the transaction. The issue of intangible goods and services was not addressed directly by P.L. 86-272.

The Internet sales and use tax debate has revived a discussion of what constitutes nexus for a corporate income tax. Clarified nexus standards, however, do

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[25] S. 1736 and H.R. 3184 in the 108th Congress.

[26] U.S. Congress, Senate Committee on Finance, *State Income Taxes — Interstate Commerce*, Senate report to accompany S. 2524, S.Rept. 658, 86th Cong., 1st sess. (Washington: GPO, Aug. 11, 1959) p. 2549.

[27] U.S. Congress, Senate Committee on Finance, *State Income Taxes — Interstate commerce*, Senate report to accompany S. 2524, S.Rept. 658, 86th Cong., 1st sess. (Washington: GPO, Aug. 11, 1959) p. 2549.

not seem destined to fundamentally alter the administration of state corporate income taxes. As noted above, current laws would already shield out-of-state vendors from corporate income tax liability if the business were only soliciting the sale of tangible goods into the state. As for intangibles goods and services, policymakers would likely insert language to ensure that a corporation would not establish nexus by virtue of collecting sales and use taxes.[28]

Tax Interaction

The "Jobs and Growth Tax Relief Reconciliation Act of 2003" (JGTRRA, P.L. 108-27), included several provisions that reduce the federal tax burden on business investment.[29] The federal tax changes also affected state taxes because of the interaction between federal taxes and state taxes on corporations. Generally, states use the federal tax code as the base for the state income tax (see the background section titled "federal starting point").[30] Thus, when the federal definition of the tax base changes, so does the state definition of income.[31]

JGTRRA included two temporary provisions designed to accelerate the depreciation of capital assets purchased by businesses. The first is a temporary increase in the amount of a capital expenditure that a small business can deduct in the year of purchase.[32] The larger deduction reduces the base of the federal corporate income tax and thus the state corporate income tax base for those states that link directly to the federal tax code. The change in federal law may generate a significant revenue loss in the short run for those states that remain linked to the federal definition of business income.[33] This provision would have expired on December 31, 2005, but was extended through December 31, 2007, by the *American Jobs Creation Act of 2004*, (P.L. 108-357).

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[28] Section 7(a) of S. 1736 from the 108th Congress states that "[N]othing in this Act shall be construed as subjecting sellers to franchise taxes, income taxes, or licensing requirements of a state or political subdivision thereof, nor shall anything in this Act be construed as affecting the application of such taxes or requirements or enlarging or reducing the authority of any State to impose such taxes or requirements."

[29] For more on the business tax cuts in P.L. 108-27, see CRS Report RL32034, *The Jobs and Growth Tax Relief Reconciliation Act of 2003 and Business Investment*, by Gary Guenther.

[30] Many states, as noted earlier, have decided not to incorporate recent federal changes. For more, see McIntyre, Robert S and T.D. Coo Nguyen, "State Corporate Income Taxes 2001-2003," *State Tax Notes*, March 7, 2005, pp. 685-712.

[31] Another issue is fiscal policy coordination between the federal, state, and local governments. If state governments do not adopt the federal tax changes, then the fiscal stimulus of federal tax policy is muted by state non-compliance. For more on the countervailing fiscal stimulus effects, see CRS Report RL31936, *General Revenue Sharing: Background and Analysis*, by Steven Maguire, p. 7.

[32] 26 U.S.C. § 179.

[33] According to a recent analysis by the Center on Budget and Policy Priorities, "...17 states stand to lose an estimated $1.1 billion in 2004 and another $600 million by the end of 2005." Nicholas Johnson, "Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years," *Center on Budget and Policy Priorities*, June 5, 2003, p. 5.

A second JGTRRA provision allowed for "bonus depreciation" for certain capital expenditures. Businesses that buy qualified capital assets before January 1, 2005 could have immediately deducted 50% of the purchase price from gross income. The combined effect of the two original provisions (not including the 2004 extension of the small business deduction described above) would cost states an estimated $2.7 billion. If the provisions were made permanent, the cost to the states has been estimated to rise to $17.7 billion over the 2004-2013 budget window.[34]

Proponents of the accelerated depreciation provisions, however, would argue that over the long run, increased business investment would likely lead to stronger economic growth and in turn *more* corporate income tax revenue. The long run net budget outcome of the two countervailing forces is uncertain and relies on debatable assumptions about the response of businesses to investment incentives delivered through the federal tax code.

The JGTRRA provisions adversely affect state budgets in the short run because the tax relief is delivered through changes in the base. If Congress were concerned primarily with the impact of federal corporate income tax law changes on the states, changes in corporate income tax *rates* would have minimal impact on the states. Unlike changes in the tax base, a federal tax rate change would not directly affect state corporate income taxes.

Legislative Activity

Some legislation in the 108th Congress would have authorized states to compel remote vendors to collect sales and use taxes.[35] Even though the bills address the collection of state sales and use taxes, not state corporate income taxes, some policymakers believe that the issues are similar to those surrounding the state corporate income tax. Related legislation would have established a "physical presence" standard for business activity taxes (BATs, primarily state corporate income taxes). Following is a brief overview of selected legislation introduced in the 108th Congress that would have affected state corporate income taxes. In the 109th Congress, H.R. 1956 adresses the nexus standards for purposes of levying a state corporate income tax.

H.R. 3184 and S. 1736 (108th Congress). Two identical bills (H.R. 3184 and S. 1736), each given the title of the "Streamlined Sales and Use Tax Act (SSUTA)," would have authorized states to require out-of-state vendors to collect sales and use taxes. The authority would only be granted once "...10 states comprising at least 20 percent of the total population of States imposing a sales tax ... have petitioned for membership under the Streamlined Sales and Use Tax Agreement...."[36] Businesses with less the $5 million in sales would have been

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[34] Nicholas Johnson, "Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years," *Center on Budget and Policy Priorities*, June 5, 2003, Tables 2 and 3.

[35] S. 1736 and H.R. 3184 in the 108th Congress.

[36] Section 4(a).

exempt from the requirement.[37] And, businesses that collect the tax would have received "reasonable compensation" from the states for expenses incurred for "administration, collection and remittance of sales and use taxes."[38] The connection to states through the sales and use tax administration has raised concern that implementing the SSUTA would pave the way for states to claim that out-of-state vendors have established nexus. Section 7 of H.R. 3184 (and S. 1736), however, outlines the limitations of the proposed SSUTA. The legislation explicitly states that "No obligation imposed by virtue of the authority granted by section 4 shall be considered in determining whether a seller has a nexus with any State for any tax purpose."[39]

H.R. 1956 (109th Congress). Under current law, sales of "tangible personal property" into a state are not sufficient to trigger tax liability. H.R. 1956 would expand the protection beyond tangible personal property to include services.[40] This expansion would have had a significant effect on the 32 states where "...an employee's solicitation of services while in the state for six or fewer days would create nexus."[41]

In addition to the expansion of protected interactions, this legislation would have also defined "physical presence" as the standard for collecting business activity taxes. Under this proposal, physical presence would be established and a business activity tax allowable if:

- the individual or business is physically within the state for 21 days (not including trips to buy goods or services for the business; gathering news for print or other media; meeting with government officials for purposes other than selling goods and services; attending training or educational purposes; or participating in charitable events),
- the individual or business uses the services of another individual or business for 21 days and the hired individual or business does not do business for any other entity, or
- the individual or business leases or owns tangible personal property or real property in the state for more than 21 days.

An important exception to the "21-day rule" is included in the legislation and is related to live performances and sporting events. Generally, the 21-day minimum is replaced with one day for live performances and participation in sporting events

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[37] Section 4(b).

[38] Section 4(c).

[39] Section 7(b).

[40] Generally, H.R. 1956 strikes the "tangible personal property" identifier and inserts "or transaction." This change would presumably expand the "protected" activity to include service transactions.

[41] BNA, April 25, 2003.

where at least 100 spectators are present. There is not a uniform number of days under current state laws, but, most states impose a minimum that is less than 21 days.

Analysis. The streamlined sales tax legislation, H.R. 3184 and S. 1736, would have required states to simplify their sales and use tax systems before granting them the authority to compel remote vendors to collect the sales and use tax. From an economic perspective, reduced complexity and compliance costs for businesses, not just those engaged in interstate commerce, would likely increase the efficiency of the tax system. To the extent that the changes imposed by the legislation would treat all transactions neutrally, they would also increase the equity of the tax system.

The critical concern is how stringent the SSUTA enforcement will be if implemented. If the agreement is not strictly enforced, then any gains in economic efficiency are lost and the anticipated improved equity diminished. The de minimus standards could be administratively difficult to enforce and could create loopholes through which businesses could circumvent the intent of the SSUTA. These standards could be eliminated if the SSUTA were strictly enforced and the rules on what was taxable were truly uniform from state to state. The ease of compliance with a truly uniform base would render seemingly arbitrary minimum sales thresholds unnecessary.[42] Even though the statutory burden of the sales and use tax falls on consumers, the SSUTA legislation may be considered in conjunction with other legislation that more directly addresses how states tax businesses.

The BAT legislation in the 109th Congress, H.R. 1956, was intended to further modify the state taxation of businesses engaged in interstate commerce. The legislation would impose new regulations on how states impose taxes on multi-state businesses, through (1) imposing uniformity on the time component of nexus determination and (2) expanding the definition of goods and services subject to the nexus rules. The legislation would not directly address the complexity of the state corporate income tax structure — in particular, the various apportionment formulas (and allocation rules) described earlier.

Many economists and other researchers who analyze state corporate income taxes agree that the critical issue with the current state corporate income tax structure is the variability in the allocation and apportionment of corporate income from state to state. The current mosaic of state corporate income tax rules creates economic inefficiencies for the following reasons: (1) relatively high compliance costs, (2) increased opportunities for tax planning by businesses, and (3) potential gaps and overlaps in taxation. The new regulations as proposed in H.R. 1956 would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have expanded the opportunities for tax planning and thus tax avoidance and possibly evasion.

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[42] Charles McClure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004, p. 732.

LETTER TO THE HONORABLE CHRIS CANNON FROM STEVE BARTLETT, PRESIDENT AND CEO, THE FINANCIAL SERVICES ROUNDTABLE: INDUSTRY COALITION

Honorable Chris Cannon
U.S. House of Representatives
Chairman, Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
B-355 Rayburn House Office Building
Washington, DC 20515

Re: Hearing on H.R. 1956, Business Activity Tax Simplification Act of 2005

Dear Chairman Cannon,

I am writing on behalf on The Financial Services Roundtable in support of H.R. 1956, the Business Activity Tax Simplification Act of 2005 and to thank you for your leadership on this important legislation. H.R. 1956 would provide a national jurisdictional standard for the imposition of state and local business activity taxes on interstate commerce. This is a very important issue for the members of The Financial Services Roundtable.

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine, accounting directly for $40.7 trillion in managed assets, $960 billion in revenue, and 2.3 million jobs.

The current system needs to be modernized. Over the past several years, many state and local taxing authorities have asserted tax liability on multi-state businesses by utilizing so-called "economic nexus" arguments. This results in a tax liability to the business, where they are already apportioning 100 percent of their income to states in which they have physical presence and utilize state resources, but no corresponding state benefits flowing back to the business. This allows a state to tax a business that merely has customers in the state, but no significant amount of property or employees. Given the nationwide nature of the financial services industry and the fact that many financial institutions offer credit cards and other products and services outside of the states in which they have physical presence, this trend will greatly hamper the economy, consumers, and competition within the industry.

Congress should act as soon as possible to create clarity and certainty for multi-state businesses and taxing authorities alike. H.R. 1956 would prohibit states and localities from imposing a business activity tax on any entity that does not have a physical presence in the taxing jurisdiction. Businesses would continue to pay business activity taxes to those jurisdictions that provide them with meaningful benefits and protections – where they have physical presence. In addition, H.R. 1956 would modernize current law (P.L. 86-272) and establish a fair, clear, and uniform nexus standard. Such clarification would, in turn, reestablish the type of state business climate that encourages increased business investment, expanded interstate commerce, and a healthy American economy.

Best Regards,

Steve Bartlett

LETTER TO THE HONORABLE F. JAMES SENSENBRENNER, JR., FROM AN INDUSTRY COALITION

September 26, 2005

AMENDED VERSION OF 7/13/05 LETTER

Honorable Jim Sensenbrenner, Jr.
Chairman, House Committee on the Judiciary
United States House of Representatives
Washington, DC 20515-4905

Dear Chairman Sensenbrenner:

The companies (both large and small), trade associations and citizen groups listed below strongly support H.R. 1956, the Business Activity Tax Simplification Act ("BATSA"), and respectfully request that your Committee consider and favorably report the bill in the first session of the 109th Congress.

BATSA, a bill recently introduced by Representatives Bob Goodlatte (R-VA), Rick Boucher (D-VA) and others, would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and other direct taxes on a business (the bill would have no impact on sales and use or other non-income-based taxes). Specifically, the bill would articulate a bright-line physical presence standard that includes owning or leasing any real or tangible property, or assigning one or more employees, or using the services of agents to perform certain activities in the state for more than twenty-one days in a taxable year.

In addition, the bill would modernize Public Law 86-272 – which prohibits states from assessing net income-based taxes against an entity whose only contact with the state involves the solicitation of orders for tangible personal property – so that it applies also to intangible property and services and to all direct taxes on a business, not just those based on net income.

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 in advance for considering our request. We look forward to working with you, your staff and all members of the House Judiciary Committee on the Business Activity Tax Simplification Act.

Sincerely-

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American Bankers Association
American Electronics Association (AeA)
American Express Company
American Financial Services Association
American Hotel & Lodging Association
American Legislative Exchange Council
Americans for Prosperity
Americans for Tax Reform
American Shareholders Association
America's Community Bankers
Apple Computer
Association for Competitive Technology
Beall's, Inc.
Blue Crab Bay Co./Bay Beyond Inc.
BMC Software, Inc.
Burger King Corporation
Business Roundtable
Cendant Corporation
Chevron Corporation
Cisco Systems, Inc.
Citigroup, Inc.
Coalition of Service Industries
Computing Technology Industry Association (CompTIA)
Council for Citizens Against Government Waste
Deere & Company
Delphi Corporation
Discovery Communication, Inc.
Eastman Chemical Company
EDS
Entertainment Software Association
Expedia, Inc.
Federated Department Stores, Inc.
The Financial Services Roundtable
FreedomWorks
Gap Inc.
IAC/InterActiveCorp.
Illinois Chamber of Commerce
Illinois Information Technology Association
Information Technology Association of America
International Franchise Association
Investment Company Institute
Iowa Taxpayers Association

Limited Brands, Inc.
Magazine Publishers of America
MESDA: Maine's Software & Information Technology Industry Association
Mary Kay Inc.
MBNA
Metris Companies Inc.
Metromedia Restaurant Group
Microsoft Corp.
Motion Picture Association of America, Inc.
National Association for the Specialty Food Trade, Inc.
National Association of Manufacturers
National Gypsum Company
National Marine Manufacturers Association
National Restaurant Association
National Retail Federation
National Taxpayers Union
NetChoice Coalition
Nevada Development Authority
Nike
North American Association of Food Equipment Manufacturers
North Carolina Biosciences Organization
North Carolina Citizens for Business and Industry
North Carolina Manufacturers Association
North Carolina Technology Association
Northeast Ohio Software Association
Pasta by Valente, Inc.
ProHelp Systems, Inc. (a home-operated S.C. business)
Saks
Securities Industry Association
Software & Information Industry Association
Software Finance and Tax Executives Council
Sony
Time Warner Inc.
The TJX Companies, Inc.
UPS
U.S. Chamber of Commerce
Viacom
The Walt Disney Company
Wendy's International, Inc.
Women Presidents' Association

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cc: Honorable Henry J. Hyde
Honorable Howard Coble
Honorable Lamar Smith
Honorable Elton Gallegly
Honorable Robert W. Goodlatte
Honorable Steve Chabot
Honorable Daniel E. Lungren
Honorable William L. Jenkins
Honorable Chris Cannon
Honorable Spencer Bachus
Honorable Robert D. Inglis
Honorable John N. Hostettler
Honorable Mark Green
Honorable Ric Keller
Honorable Darrell Issa
Honorable Jeff Flake
Honorable Mike Pence
Honorable J. Randy Forbes
Honorable Steve King
Honorable Tom C. Feeney III
Honorable Trent Franks
Honorable Louie Gohmert
Honorable John Conyers, Jr.
Honorable Howard L. Berman
Honorable Rick Boucher
Honorable Jerrold Nadler
Honorable Robert C. Scott
Honorable Melvin L. Watt
Honorable Zoe Lofgren
Honorable Sheila Jackson Lee
Honorable Maxine Waters
Honorable Martin T. Meehan
Honorable William D. Delahunt
Honorable Robert Wexler
Honorable Anthony D. Weiner
Honorable Adam Schiff
Honorable Linda Sanchez
Honorable Chris Van Hollen, Jr.
Honorable Debbie Wasserman-Schultz

LETTER TO THE HONORABLE CHRIS CANNON, AND THE HONORABLE MELVIN WATT, FROM JOHN GAY, VICE PRESIDENT, GOVERNMENT RELATIONS, INTERNATIONAL FRANCHISE ASSOCIATION (IFA)

September 27, 2005

The Honorable Chris Cannon
U.S. House of Representatives
House Committee on the Judiciary
Chairman, Subcommittee on Commercial and Administrative Law
B-353 Rayburn House Office Building
Washington, DC 20515

The Honorable Melvin Watt
U.S. House of Representatives
House Committee on the Judiciary
Ranking Member, Subcommittee on Commercial and Administrative Law
B-351 Rayburn House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act (H.R. 1956)

Dear Chairman Cannon and Rep. Watt:

The International Franchise Association (IFA) would like to express strong support for the Business Activity Tax Simplification Act ("BATSA") (H.R. 1956). BATSA would answer the need for a fair, clear and uniform nexus standard for the imposition of business activity taxes by states and localities.

Who we are:

The IFA is a trade association of more than 1,000 franchising companies and 8,000 franchise members, representing over 75 industries. The association's mission is to enhance and to safeguard the business environment for franchising worldwide; and it is the only association serving as the voice for franchising in the United States. The over 767,000 franchised businesses in the U.S. account for more than one and a half trillion dollars of economic output (about 9.5% of the private-sector economic output). Franchisors and their franchisees directly employ almost 10 million people, and indirectly are responsible for the creation of over 18 million jobs. The great majority of the approximately 2,500 franchisors operating in the U.S. are small businesses, with fewer than 50 franchised outlets.

What BATSA Does:

BATSA would codify current law (which itself is derived from the Constitution's Commerce Clause) to ensure that states and localities may impose their business activity taxes only in situations where an entity has physical presence (*i.e.*, property or employees) and thereby receives related benefits and protections from the jurisdiction. We agree that a physical presence nexus standard should be preserved in order to ensure an equitable and measurable application of the state tax laws for all industries.

Why the Franchise Industry Supports BATSA:

Enactment of BATSA is important to the franchise industry 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 (*i.e.*, intangible 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.

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 business and to inspect the franchisee's performance and furnish 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.

The franchise relationship evolved over the last half century with the understanding that the franchisor is not subject to state income taxes (other than those imposed by the franchisor's domicile state) on the royalty income paid to the franchisor by franchisees located in a different state. Prior to the late 1980s, with rare exception, the states did not seek to tax such income, unless the franchisor clearly established a traditional nexus by owning or leasing real estate, operating its own outlets, or maintaining an office or employees in the taxing state.

Recently, however, some state revenue departments have 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. Such arguments radically expand the classes of persons, relationships and transactions potentially subject to state income taxation.

The issue has enormous implications for the many thousands of businesses engaged in interstate franchising and licensing of intangible property, a rapidly expanding part of the

American economy. 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 businesses. Unless addressed, the continuing uncertainty with respect to such issues will impose high costs on companies forced to operate in an environment in which their state tax liabilities are unclear.

Conclusion:

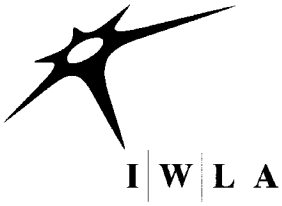
States that attempt to assess taxes on businesses with no physical connection to the jurisdiction would substantially extend the reach of state taxing powers to companies having no contact with the taxing state by interpreting significant constitutional limits on these powers so narrowly as to effectively eliminate them. If every state where a franchisor has granted franchises may tax its income attributable to that state, franchisors will be subject to costly compliance burdens and overlapping taxes. Thus, enactment of BATSA is critical for thousands of businesses, franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Thank you for considering this written testimony.

Sincerely,

John Gay
Vice President, Government Relations
International Franchise Association

PREPARED STATEMENT OF DAVID J. PETTIT, PRESIDENT, AMERICAN DISTRIBUTION CENTERS FOR THE INTERNATIONAL WAREHOUSE LOGISTICS ASSOCIATION



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STATEMENT

OF

DAVID J. PETTIT, PRESIDENT

AMERICAN DISTRIBUTION CENTERS

SALT LAKE CITY, UTAH

FOR THE

INTERNATIONAL WAREHOUSE AND LOGISTICS

ASSOCIATION

FOR THE RECORD

OF THE

LEGISLATIVE HEARING ON HR 1956,

"BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005"

BY THE

HOUSE JUDICIARY COMMITTEE

SUBCOMMITTEE ON COMMERCIAL

AND ADMINISTRATIVE LAW

SEPTEMBER 27, 2005

IWLA ANNUAL CONVENTION
WYNN LAS VEGAS
MARCH 19-22, 2006

"Serving Our Members and the Industry Since 1891"

STATEMENT OF DAVID J. PETTIT, PRESIDENT

AMERICAN DISTRIBUTION CENTERS

SALT LAKE CITY, UTAH

FOR THE

INTERNATIONAL WAREHOUSE AND LOGISTICS ASSOCIATION

American Distribution Centers (ADC), based in Salt Lake City, as a member of the International Warehouse and Logistics Association (IWLA) is pleased to submit this statement for the record of the hearing on H.R. 1956, the Business Activity Tax Simplification Act of 2005 (BATSA). I am President of ADC and Vice Chairman of IWLA. We support the overall purpose of this legislation – to clarify that "physical presence" is the appropriate standard for business activity taxation by states and to provide a "bright line" test to determine physical presence in a state. However, HR 1956 does not recognize the unique circumstances when inventory is held for distribution in a public warehouse and, as currently written, actually would be more harmful than current law in this regard.

IWLA is the unified voice of the global logistics industry, representing 3PLs (third-party logistics providers), public and contract warehouse companies and their suppliers. Since 1891, our Association has been working to promote and advance the logistics outsourcing industry. IWLA members worldwide ship more than three trillion pounds of goods annually and operate more than 400 million square feet of public and contract

warehouse space, providing the most timely and cost-effective global logistics solutions for their customers.

The Business Activity Tax Simplification Act: The Business Activity Tax Simplification Act (H.R. 1956) is designed to address a fundamental problem related to interstate commerce, that is, the issue of when a state should have authority to impose tax on a business located outside the state and with only a minimal connection to the state.

The Constitution requires that an out-of-state business have a sufficient connection, or "nexus," with the state before that state can impose an income or business activity tax. Increasingly, states are expanding this concept, developing an "economic nexus" theory that dramatically enlarges the reach of states to impose income taxes or other business activity taxes on out-of-state companies. This trend impacts virtually every business operating in interstate commerce. While H.R. 1956 resolves this problem for some, it does not resolve it for manufacturers, wholesalers and others who use public warehouses to distribute their product in interstate commerce.

Public Warehousing and Business Activity Taxes: The public warehouse provides warehousing and other third-party services to many businesses during the course of the year. Product is transported to and from the warehouse continuously as it travels to its final destination in the marketplace. In a public warehouse (as opposed to a private warehouse), the public warehouse owner enters into a contractual agreement with the

customer to provide care, custody and control of the customer's merchandise. Article 7 of the Uniform Commercial Code governs such contracts.

The nature of the bailment relationship between the public warehouse and its customer negates a claimed entitlement on the part of the state to impose taxes against the owner of the goods. In this bailment relationship, the goods are placed in the custody and control of the bailee warehouse, so there is no "presence" of the bailor that would entitle the state in which the public warehouse is located to impose its taxes on the bailor.

By contrast, in traditional "private warehousing," a company maintains its own warehouse facility and continues to be responsible for the care, custody and control of the products it owns. In these circumstances, the owner of the product does indeed establish a physical presence when his private warehouse is located in a state.

Many states, however, include "warehousing" in general as an activity that establishes a tax nexus, without making a distinction between "private warehousing" and "public warehousing." For a public warehouse, which may have custody and control of products from 50 or more customers at any one time, this means that the state can tax each and every one of the 50 customers whose product is being held for distribution.

Recommended Solution: In its present form, HR 1956 provides that merchandise in a state for more than 21 days can subject the out-of-state owner to state taxation. For a public warehouse, this new federal standard would do more harm than good by setting

an arbitrary 21-day period (in federal law) after which goods in a public warehouse can be subject to state taxation.

Currently, HR 1956 exempts from the 21-day standard tangible personal property that is in the state for assembling, manufacturing, processing or testing. IWLA recommends that HR 1956 be amended to also exempt from the 21-day standard tangible personal property "held for distribution in interstate commerce by a third party." This is a narrow amendment that achieves a result consistent with the overall intent of the legislation.

Inventory maintained in a public warehouse remains in "interstate commerce." Court decisions have found that, for the purposes of state regulation, public warehousing is a continuation of the product's journey in interstate commerce. Similarly, for purposes of state taxation, in states such as Ohio, inventory brought into the state for storage only, held within public warehouses, and then shipped outside of Ohio for use is exempt from tangible personal property taxation. Just as transporting a product through a state does not trigger "physical presence" for the product's owner, neither should temporary storage in a public warehouse establish "physical presence" for the owner of the product.

It should also be noted that in no way does IWLA's proposed amendment diminish the public warehouse owner's obligation to pay taxes in the state in which the warehouse is located. This is consistent with the established principle that taxes should be imposed on those who receive the benefits and protections from the state. It is the public warehouse that is legally responsible for the safe care of the product stored in the

warehouse. It is the public warehouse that receives the benefits of fire and police protection and other services provided by the state and local government in which the public warehouse is located. As such, the public warehouse will continue to pay its share of taxes with the state. The proposed amendment only limits taxation of the owner of the product that temporarily is held in the warehouse for distribution in interstate commerce.

We respectfully request that the Committee favorably consider IWLA's proposed amendment and we look forward to working with the Committee on this issue. Thank you for the opportunity to comment on HR 1956.

LETTER TO THE HONORABLE CHRIS CANNON FROM DAN GLICKMAN, CHAIRMAN AND CEO, MOTION PICTURE ASSOCIATION OF AMERICA

September 26, 2005

Honorable Chris Cannon
House Judiciary Commercial and Administrative Law Subcommittee
United States House of Representatives
Washington, DC 20515-4905

Dear Congressman Cannon:

I am writing on behalf of our Member Companies, Buena Vista Pictures Distribution; Metro-Goldwyn-Mayer Studios Inc.; Paramount Pictures Corporation; Sony Pictures Entertainment Inc.; Twentieth Century Fox Film Corporation; Universal City Studios LLLP; and Warner Bros. Entertainment Inc., in support of H.R. 1956, the Business Activity Tax Simplification Act ("BATSA"), and respectfully request that your Subcommittee consider and favorably report the bill in the first session of the 109th Congress.

BATSA, a bill recently introduced by Representatives Bob Goodlatte (R-VA), Rick Boucher (D-VA) and others, would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and other direct taxes on a business (the bill would have no impact on sales and use or other non-income-based taxes). Specifically, the bill would articulate a bright-line physical presence standard that includes owning or leasing any real or tangible property, or assigning one or more employees, or using the services of agents to perform certain activities in the state for more than twenty-one days in a taxable year.

In addition, the bill would modernize Public Law 86-272 – which prohibits states from assessing net income-based taxes against an entity whose only contact with the state involves the solicitation of orders for tangible personal property – so that it applies also to intangible property and services and to all direct taxes on a business, not just those based on net-income.

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 in advance for considering our request. We look forward to working with you, your staff and all members of the House Judiciary Commercial and Administrative Law Subcommittee on the Business Activity Tax Simplification Act.

Sincerely,

Dan Glickman

PREPARED STATEMENT OF THE NATIONAL GOVERNORS ASSOCIATION, SUBMITTED BY THE HONORABLE WILLIAM D. DELAHUNT

IMPACT OF H.R. 1956, BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005, ON STATES

September 26, 2005

Executive Summary

On April 28, 2005, H.R. 1956, the "Business Activity Tax Simplification Act of 2005" was introduced in Congress by Representatives Rick Boucher and Bob Goodlatte of Virginia. The bill would impose a federal physical presence standard for determining when a state can impose a business activity tax (BAT). In order to determine the impact of a bright-line nexus for state business activity taxes, the National Governors Association worked with the Federation of Tax Administrators (FTA) and the Multi-state Tax Commission (MTC) to survey state revenue agencies asking them to estimate the impact of such legislation on their respective state.[1]

All of the 34 states responding to the survey have stated that the legislation would adversely affect their business activity tax (BAT) revenue. The range of taxes affected is broad and includes gross receipts, gross income (including Washington State's Business and Occupation Tax), taxes imposed on vendors for the privilege of doing business, taxes on receipts of public utilities, and taxes imposed in lieu of net income taxes and similar types of taxes. Based on information from responding states, H.R. 1956 would reduce BAT revenues by an average of 10.4%. Extrapolating to all states, H.R. 1956 would cost states and localities an estimated *$6.6 billion annually*.

Examples provided by responding states indicate H.R. 1956 would upset settled law regarding state business activities of numerous industries including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software. Sellers of services and intangibles would come under a new physical presence standard that exceeds the provisions in PL 86-272 for sellers of tangible personal property. This extension, along with other provisions in the bill, would create new opportunities for businesses to structure their operations so as to avoid most state business activity taxes entirely. Certain provisions, (e.g., the ability for other parties to perform work on the company's behalf, the 21 day exemption, and carve outs for specific industries) present likely sources of revenue impact.

Although the sponsors have indicated their bill would achieve the goal of creating legal certainty that would minimize litigation, it appears that H.R. 1956 could have the opposite effect. Opportunities for businesses to reorganize in order to avoid taxes would shift the areas of litigation to new ground. The reorganizations and perhaps physical relocations would also burden the economy as businesses expend resources for non-productive purposes. In addition, H.R. 1956 would legalize certain tax sheltering practices and income shifting methods that several states consider questionable.

In this survey, state revenue estimators were asked to estimate the revenue impact on their state in three ways – the static effect, dynamic effect, and compliance effect. A static effect captures how the new law would allow some companies, currently filing, to be free to stop filing. The dynamic or behavioral effect asks what happens to revenue when companies restructure or change operations to use the provisions of H.R. 1956 to minimize their BAT liability. The

[1]This survey was originally conducted in response to a virtually identical bill introduced during the 108th Congress, H.R. 3220, the "Business Activity Tax Simplification Act of 2003." Because of the similarity between the two bills, several states used their original estimates to calculate the impact of H.R. 1956.

compliance effect is the loss of anticipated revenue from enforcement efforts to curb current illegal tax sheltering or income shifting activities that would be made legal if the bill were to become law. The estimates for the dynamic effect are somewhat larger than for the static effect, although the dynamic effect includes a wider range of estimates, representing less certainty. The compliance effect is significantly smaller than the static or dynamic estimates.

As the report indicates, the federally mandated physical presence standard in H.R. 1956 would have a significant impact on the revenues of nearly every state. The bill's extension of the physical presence standard beyond tangible personal property sales, and its addition of carve outs and exemptions for certain industries and practices, only increase its adverse impact. Governors urge Congress to oppose H.R. 1956 and leave decisions regarding state revenues to the states.

I. Introduction and Draft Description of Survey

On April 28, 2005, H.R. 1956, titled the "Business Activity Tax Simplification Act of 2005" was introduced in Congress by Representatives Rick Boucher and Bob Goodlatte of Virginia. This bill is strikingly similar to H.R.3220, the "Business Activity Tax Simplification Act of 2003." introduced by Representatives Boucher and Goodlatte on October 1, 2003. The purposes of this proposed legislation, according to Representative Bob Goodlatte of Virginia are:

- To provide a "bright line" that clarifies state and local authority to collect business activity taxes from out-of-state entities.
- To set specific standards to govern when businesses should be obliged to pay business activity taxes to a state. Specifically, the legislation establishes a "physical presence" test such that an out-of-state company must have a physical presence in a state before the state can impose franchise taxes, business license taxes, and other business activity taxes.
- To ensure fairness, minimize litigation, and create the kind of legally certain and stable business climate that encourages businesses to make investments, expand interstate commerce, specifically electronic commerce, grow the economy and create new jobs.
- To ensure that states and localities are fairly compensated when they provide services to businesses with a physical presence in the state.[2]

Although the underlying premise – a uniform state business activity tax jurisdictional standard – may be desirable to some, this bill would, if enacted, have adverse impacts on state and local governments. In-depth analysis of this bill reveals that preemption of state and local authority would expand in four dimensions:

1) The bill would expand the type of taxes preempted from income taxes to a wide variety of state and local business activity taxes.
2) The bill would expand the range of businesses benefiting from the preemption of state and local authority from only businesses selling tangible goods to all businesses making sales, including the sale of services and intangibles.
3) The bill would impose new, broad restrictions on state jurisdictional authority for state and local business activity taxes by establishing a general physical presence standard of nexus for such taxes; and
4) The bill would provide for a wide variety of exceptions to physical presence: temporary and permanent physical activities in a state that would allow business entities to be exempt from a state and local business activity tax even if they had a physical presence in a jurisdiction.

The taxes affected by this proposed legislation include corporate income taxes and other business activity taxes (transactions taxes are not affected by the bill). Other business activity taxes include:[3]

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[2] Remarks of Representative Bob Goodlatte, reprinted in ***State Tax Notes***, Doc 2005-9147, May 3, 2005, Tax Analysts, Inc., Arlington, VA

[3] H.R. 1956 Section 4(1) and 4(2)(A) and 4(2) (B).

- A tax imposed on or measured by gross receipts, gross income, or gross profits;
- A business license tax;
- A business and occupation tax;
- A franchise tax;
- A single business tax or a capital stock tax;
- Any other tax imposed by a state on a business for the right to do business in that state or measured by the amount of, or economic results of, business or related activity conducted in that state. [4]

Taxes on gross receipts, gross income, or gross profits include Washington State's Business and Occupation Tax, taxes imposed on vendors for the privilege of doing business at retail, taxes on receipts of public utilities and taxes imposed in lieu of net income taxes and similar types of taxes.[5] Business license taxes and business and occupation taxes include taxes and fees which are imposed on persons and businesses not domiciled in a state for the privilege of conducting business in that state. For example, a state may impose a license tax on out-of-state financial services companies, electricity marketers, and similar types of businesses for the privilege of conducting business in that state, regardless of whether these businesses have a physical presence, as defined in H.R. 1956, in that state. Local governments in that state that impose taxes similar to the ones illustrated above would be similarly prohibited from imposing these taxes. In 2004, state and local business activity taxes, using the definition of these taxes contained in the bill were $89.8 billion; or, 9.7 percent of state and local government tax revenues ($925.5 billion). In 2003, the estimated level of business activity taxes was $99.8 billion – 10.4 percent of state and local tax revenues – $964.2 billion.[6]

H.R. 1956 treats an individual's or an employee's presence in a state as not constituting physical presence if the individual or employee is in the state for 21 days or less, *for any purpose*. Similarly, a firm can have any amount of property in a state for 21 days or less and not have physical presence in a state. This proposed legislation would expand both the number and quality of contacts that an entity or individual can have in a state and still be exempt from that state's taxation. Some of the safe harbors would permit businesses to own property (in some cases, real property) in this state, for extended periods of time, without incurring a state tax liability. Additionally, H.R. 1956 would legalize certain tax shelters or income shifting methods that a number of states consider questionable.

Desirability of Physical Presence as the Nexus Standard for Business Activity Taxes
As Congressman Goodlatte correctly notes, the growth of the Internet increasingly enables companies to conduct transactions without the constraint of geopolitical boundaries. The growth of remote interstate business-to-business and business-to-consumer transactions raises questions

[4] Note that such taxes need not be levied on all businesses, but may be taxes for the right of doing business or earning income from particular activities. Examples include utility gross receipts taxes levied for the right of conducting telecommunications, electrical supply or similar activities.
[5] Insurance gross premiums taxes are not included in the possible list of state taxes that may be preempted by H.R. 1956 because it was concluded by MTC legal staff that these taxes were protected by the McCarran-Ferguson Act.
[6] U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Products Accounts, http://www.bea.doc.gov/bea/dn/nipaweb/TableView.asp#Mid

over where multi-state companies should be required to pay corporate income and other business activity taxes.[7] Proponents of a physical presence based nexus standard assert that:

> "…Public Law 86-272 must be modernized to address the shift in the focus of the economy from goods to services and intangibles, the increased burdens being imposed by local taxing jurisdictions, and the proliferation of non-income based business activity taxes."[8]

Furthermore, the proponents of a physical presence based nexus standard assert that business firms receive benefits from state and local governments only in those states in which they have a physical presence, and that the business activity taxes imposed on firms with physical presence will adequately compensate those governments for the services provided to local businesses.[9]

There are, however, compelling arguments against a physical presence based nexus standard for business activity taxes in general and against H.R. 1956 in particular. Professor Charles McLure of the Hoover Institution Stanford University, argues that Public Law 86-272 does not provide a desirable basis for state business activity nexus. In an article in the December 2000 ***National Tax Journal***, Professor McLure states:

> "Current rules for determining income tax nexus fail miserably. P.L. 86-272 has been justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income taxes from corporations deriving income from within their borders."[10]

The argument that *only* those business firms physically located in a state receive any benefits from state expenditures and therefore should not be required to pay business activity taxes in those states in which they do not have physical presence is not true. The Economics of Public Finance literature has a long history of defining and classifying types of public services and the most economically efficient ways of financing those expenditures. For example, the benefits of state and local expenditures shows that the benefits of those expenditures often "spillover" to other jurisdictions and accrue over long periods of time, thus making it nearly impossible to assign specific benefits to specific businesses or individuals.[11] In such cases, these generalized benefits are usually financed by generalized taxes, such as income taxes or other taxes measured by ability to pay.

Furthermore, firms with little or no physical presence in a state generally pay very little in the way of state and local business activity taxes to those jurisdictions.[12] Government benefits to business firms with a physical presence within a state are largely financed through property taxes

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[7] Goodlatte, *op. cit.*
[8] www.batsa.org.
[9] Remarks of Representative Bob Goodlatte, reprinted in ***State Tax Notes***, Doc 2005-9147, ***op. cit.***
[10] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume LIII, No. 4, Part 3, December 2000, p. 1297.
[11] Wallace E. Oates, "An Essay on Fiscal Federalism," ***Journal of Economic Literature***, Vol. 37, September 1999, p. 1128.
[12] http://www.batsa.org/FAQ.htm#ANS17

on the business' real and tangible property and by sales/use taxes on the purchase of business inputs. Nationally, these taxes account for 38.6 and 24.8 percent relatively of state and local taxes imposed on businesses in fiscal year 2003. Business activity taxes in contrast accounted for 18.0 percent of state and local taxes imposed on businesses in that year.[13]

Even if Congress chooses to limit the nexus standard for business activity taxes to a physical presence based standard, the question arises: is enactment of H.R. 1956 the best method of achieving that goal? Supporters of H.R. 1956 assert that enactment of this bill would not result in any significant loss of revenues to states because businesses would not restructure in order to take advantage of the safe harbors contained in the bill.[14] However, a recent analysis by the Congressional Research Service on H.R. 3220 from the 108th Congress notes that:

> "The new regulations as proposed in H.R. 3220 would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have expanded the opportunities for tax planning and thus tax avoidance and possibly evasion." [15]

Preliminary Findings

A major finding of this survey is that if H.R. 1956 is enacted, the bill would upset settled law regarding state business activity taxation of numerous industries, including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software.

If H.R. 1956 is enacted the estimated revenue impact in fiscal year 2007, for the 34 states that have responded to the survey would range from approximately $3.3 billion, or approximately 8.2 percent of projected business activity tax revenues in that year to $5.5 billion, or approximately 12.7 percent of projected business activity tax revenues. The "best" estimate of the impact is approximately $4.6 billion, or approximately 10.4 percent of projected business activity tax revenues in that year. Applying these proportionate revenue impacts to all states, the projected revenue impact in fiscal 2007 would range from $4.7 billion to $8.0 billion; the "best" estimate would be $6.6 billion. The estimated revenue impacts would range from 8.2 percent of projected business activity tax revenue in fiscal year 2007 to 13.8 percent; the "best" estimate would be 11.4 percent (See Table 1).

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[13] Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in Fiscal 2003," ***State Tax Notes***, Document 2004-1774, Tax Analysts, Inc., Arlington, VA, March 1, 2004, p. 738.

[14] http://www.batsa.org/FAQ.htm#ANS16

[15] Steven Maguire, ***State Corporate Income Taxes: A Description and Analysis***, CRS Report for Congress, Order Code RL32297, updated March 9, 2005, p.14.

Table 1: Estimated Revenue Impact of H.R. 1956
Fiscal Year 2007

Effect	Estimated Impact: Fiscal Year 2007		
	Minimum Impact	Best Estimate	Maximum Impact
	(Millions)		
Total Effect	***$4,718.6***	***$6,588.3***	***$7,968.1***
Static Effect	2,216.7	2,639.4	3,061.5
Dynamic Effect	2,124.4	3,463.4	4,403.9
Compliance Effect	364.7	366.7	368.1
Effect	(Percent of Projected Business Activity Taxes)		
Total Effect	8.2%	11.4%	13.8%
Static Effect	3.3	4.1	4.7
Dynamic Effect	3.5	5.6	7.1
Compliance Effect	0.6	0.6	0.6

Sources: Multistate Tax Commission estimates based on State Revenue Agency responses to survey of potential impact of H.R. 1956 in fiscal year 2007; and, U.S. Department of Commerce, Bureau of the Census Bureau of Economic Analysis.

Beyond the effect on revenue, H.R. 1956, if enacted, would cause a significant, but unmeasured burden on the economy. The special provisions of the bill would most likely induce a number of firms to reorganize in order to take advantage of those provisions. These reorganizations absorb the resources of the firms but would not result in greater efficiency or productivity. Furthermore, if business firms alter the location of existing plant and/or personnel to take advantage of the provisions of this bill, the result is economically inefficient locations of production.

Description of Survey
On April 23, 2004, the FTA and MTC sent a survey to each state asking them to estimate the impact of a federal physical presence standard, on their state. As of this date, 34 states have responded to the BAT survey. The survey instrument contains background explanation and staff analysis of the legislation, and four response sections:

1. *Section I. Legal and Enforcement Analysis.* This section asks for a complete list of each state's statutes and regulations that would be overturned if H.R. 1956 were enacted. The section consists of three parts:

Part A. – Identification of the type of tax to which the regulation or statute applies and the citation of the applicable provision.
Part B. – Provision of a brief factual description of court cases affected, including the type of tax and the amount of income and tax involved.
Part C. – Examples of current enforcement activity that would be precluded by H.R. 1956.

2. *Section II. The Revenue Estimate.* This section asks for estimates of the revenue impact of H.R. 1956 on each state. It asks state revenue estimators to estimate the impact on their state in three ways:
    - *Static effect*: Some companies that currently comply with state BAT laws would, under the new nexus standards, be free to stop filing.
    - *Dynamic or Behavioral effect*: Estimates the revenue effect when companies restructure or change operations to use the provisions of H.R. 1956 to minimize their BAT liability.
    - *Compliance effect*: The loss of anticipated revenue from enforcement efforts to curb current tax sheltering or income shifting activity.

Guidelines for estimating the revenue impact on state and local governments are included in this part.

3. *Section III. Case Study Examples of Inequitable Taxpayer Results That Would be Created by H.R. 1956.*

4. *Section IV. State Responses to Examples of "Horror" Stories Raised by Proponents of Physical Presence Nexus Standard.*

The remainder of this analysis presents the preliminary findings from state responses to two sections of the survey. First is the legal analysis portion, corresponding to Section I of the survey. Second is the revenue impact analysis, corresponding to Section II of the survey.

II: Preliminary Estimates of the Legal Impact of H.R. 1956

Preliminary Findings

This section summarizes the likely effects of H.R. 1956 on the states' existing authority under the Commerce Clause and/or PL 86-272 to impose a business activity tax on a multistate business. For the most part, the cases described below were identified by the states responding to the H.R. 1956 survey as likely to be affected should H.R. 1956 become law. In preparing this analysis, we have relied on the facts as determined in each case, rather than construct hypothetical factual scenarios against which the effects of H.R. 1956 are measured. Accordingly, this section is intended to present a real world analysis of H.R. 1956 by explaining how the results of actual cases are likely to be affected by the bill.

1. **H.R. 1956 will preempt the states' authority to impose a business activity tax on a company operating through a wholly owned dependent contractor.**

Currently, a business that solicits or makes sales through an independent contractor is within the PL 86-272 safe harbor. In order to be considered an independent contractor, the representative must have more than one principal. The RDA case described below is indicative of how H.R. 1956 would interact with current state law.

RDA is a Delaware corporation headquartered in New York State. It publishes and sells Reader's Digest. All sale orders are accepted and filled outside California. RDA does not own, lease or maintain any facilities or bank accounts in California, and has no California employees. Under these facts, the California FTB conceded that PL 86-272 preempted California from taxing RDA.

RDS&S, a wholly owned subsidiary of RDA, is a Delaware corporation that was headquartered in New York during the years at issue. RDS&S maintained two offices in California during the tax years in question and was subject to California franchise tax.

RDS&S solicited sales of advertising in domestic and foreign editions of Reader's Digest, on behalf of RDA and RDA subsidiaries that publish various editions of the magazine. It also solicited advertising sales on behalf of at least four foreign companies (in which RDA had no ownership interest) that published foreign language editions of Reader's Digest.

RDS&S was the only entity that sold or solicited the sale of advertising in the United States for any edition of Reader's Digest. RDA required all subsidiaries and foreign companies publishing the magazine to use RDS&S as their advertising broker in the United States. RDS&S did not solicit advertising sales on behalf of any publication other than Reader's Digest.

RDA reviewed and executed the RDS&S lease in California and administratively oversaw the properties of RDA subsidiaries. RDA performed accounting functions, administered the employee benefit plans and purchased all insurance for RDS&S. In its consolidated financial statements, RDA eliminated all "intercompany" net sales and operating revenue between RDS&S and RDA and its other affiliates, asserting that RDS&S was part of RDA's unitary business.

In *Reader's Digest Association, Inc. v. Franchise Tax Board,* 94 Cal. App. 4th 1240, 115 Cal. Rptr. 2d 53 (CA Ct. App. 2001), *review denied,* 2002 Cal. LEXIS 1786 (CA 2002), the California Court of Appeal ruled that RDS&S was not acting as an independent contractor within the meaning of PL 86-872 in selling advertising for RDA and other affiliates of RDA. Therefore, the Court held that RDA's income and sales factors were properly included in the unitary business apportionment formula on the California franchise tax return.

H.R. 1956 would overrule *Reader's Digest.* Section 3(b)(2) of the bill would allow a business to escape business activity tax in a state if it uses the services of another person to establish and maintain its market in the state, as long as the person performs similar functions on behalf of at least one other business entity during the taxable year. There is no requirement in H.R. 1956 that the business entities are unrelated or that the person is an independent contractor. Therefore, under the facts of *Reader's Digest,* California would be preempted from imposing its corporate franchise tax on RDA, notwithstanding that RDS&S only sold advertising on behalf of Reader's Digest and that, at least in the United States, all of RDS&S' clients were RDA affiliates.

2. H.R. 1956 will substantially preempt the states' authority to impose a properly apportioned income tax on interstate motor carriers.

McAdams, an Arkansas corporation, was an ICC-certified irregular route motor common carrier transporting commodities in interstate commerce. For the tax years in question, McAdams' percent of total miles traveled in Virginia to total miles traveled ranged from 1.23% to 3.14%. On average, its deliveries into Virginia from points outside the state ranged from 35 to 51 during the tax years at issue. Its pick-ups in Virginia for delivery outside the state during this period ranged from 1 to 9 per year. There were no intrastate pick-ups or deliveries and the interstate pick-ups and deliveries which either began or ended in Virginia constituted only 5% of the miles McAdams traveled within the state. The remaining 95 percent of the miles McAdams traveled in Virginia were "bridge miles."[16]

Virginia imposes a corporate income tax on the Virginia taxable income of every foreign corporation having income from Virginia sources. Income can be derived either from the ownership of any interest in real or tangible personal property in the state, or from a business, trade, profession or occupation carried on in the state. In the case of motor carriers, any carrier which travels less than 50,000 miles annually through Virginia or which makes fewer than twelve round trips annually into the state is excluded from the tax. McAdams exceeded these *de minimis* amounts in each of the years in question.

In applying its income tax to the income derived by interstate motor carriers within Virginia, the state uses an apportionment formula, the numerator of which is the total miles traveled in Virginia for the tax year and the denominator of which is the total miles traveled everywhere that year.

In *Virginia Department of Taxation v. B.J. McAdams, Inc.*, 227 Va. 548, 317 S.E.2d 788 (1984), the Virginia Supreme Court ruled that a properly apportioned income tax imposed on interstate motor carriers was consistent with the Commerce Clause.

In ruling that the Virginia tax was consistent with the Commerce Clause, the Virginia Supreme Court found sufficient nexus to impose the tax because of McAdams' use of the Virginia highway system, and the state's provision of police protection and similar benefits to the taxpayer.

H.R. 1956 would upset settled law in Virginia and in most states regarding the income taxation of interstate motor carriers doing business within the taxing state. The 21 day rule in Section 3(b) (1) and (2) would preempt a state from imposing a business activity tax on an interstate motor carrier that was present in the state for no more than 21 days in the taxable year, acting either through employees or through another person. Furthermore, if the interstate motor carrier utilized the services of another person who performed similar functions on behalf of at least one additional business entity during the taxable year, the state would be preempted from imposing business activity taxes on the carrier even if the other person were present in the taxing state for more than 21 days. (Section 3(b) (2)). As a result, an interstate motor carrier could structure

[10] "Bridge miles" consist of miles driven through a state from an origin outside the state to a destination outside the state, without any pick-ups or deliveries within the state.

itself so that its delivery affiliate performed similar functions exclusively for affiliated entities and immunize its entire income from state taxation.[17]

3. **H.R. 1956 would overrule established precedent by allowing businesses to engage in activities that are not ancillary to solicitation without incurring business active tax liability.**

The United States Supreme Court has ruled that activities that are not ancillary to sales solicitation – those activities that serve an independent business function apart from their connection to the soliciting of orders – do not come within the safe harbor from taxation established by PL 86-272. *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 506 U.S. 214 (1992). Accordingly, such activities as a salesman's replacing stale product for a retailer, a salesman's storage of product other than samples or replacing product for the retailer for consideration all serve independent business functions apart from their connection to the soliciting of orders and take the business out of the PL 86-272 safe harbor.

H.R. 1956 would effectively overrule *Wrigley* because of the 21 day rule and/or excluding from the definition of "physical presence," persons performing similar functions on behalf of one additional business entity other than the taxpayer.

In *Chattanooga Glass Company v. Strickland*, 244 Ga. 603, 261 S.E. 2d 599 (1979), the Georgia Supreme Court ruled that an out-of-state bottle manufacturer exceeded the protection of PL 86-272 by engaging in certain in-state activities that were not incidental to solicitation. Among those activities were: (1) one or two visits to Georgia per year by the company's customer service personnel to, among other things, remedy customer problems with previously purchased bottles, (2) maintaining property in Georgia, in the form of containers to store broken glass for later use as raw material in the company's glass manufacturing operations, and (3) purchasing the broken glass for use as raw material. Any of these activities would be viewed as not ancillary to solicitation under the *Wrigley* test, whether or not performed by sales personnel.

H.R. 1956, Section 3(b) (1) (A) would allow Chattanooga Glass to remedy customer problems under these facts, because the employees were not present in the state for more than 21 days. Furthermore, the company could exceed the 21 day limit by forming an affiliate to resolve such problems, and still not create the requisite physical presence required by the bill, as long as the affiliate performed similar functions on behalf of one additional business entity, including another affiliate. Section 3(b)(2). Section 3(b)(3) (c), in conjunction with Section 3(b)(2), would allow the company to maintain containers for broken glass within the State and to purchase broken glass in Georgia without incurring business activity tax liability, as both activities can be viewed as establishing or maintaining a market in the state by securing a source of raw material.

4. **H.R. 1956 would upset longstanding settled law by extending PL 86-272 to taxes other than taxes on or measured by net income.**

[17] The delivery affiliate itself would remain subject to state taxation, as long as it was present in the state for more than 21 days in a taxable year. But the corporate tax base would be substantially reduced.

Currently, PL 86-262 only applies to a "net income tax" which is defined as a tax imposed on or measured by net income. H.R. 1956 would greatly expand the range of state taxes preempted by PL 86-272. In addition to the net income tax, H.R. 1956 also applies to the other business activity taxes defined in Section 4(2) (A) of the bill. If enacted into law, this would have a profound effect on settled law regarding nexus to impose a state business activity tax other than a net income tax.

For example, the Washington business and occupation tax is imposed on "the act or privilege of engaging in business activities" in the state. The tax applies to the following activities in Washington: extracting raw materials, manufacturing, or making wholesale or retail sales. The measure of the selling tax is the "gross proceeds of sale" and the measure of the manufacturing tax is the value of the manufactured products.

In *Tyler Pipe Industries v. Washington Department of Revenue,* 483 U.S. 232 (1987), the United States Supreme Court ruled that the presence of one independent contractor soliciting sales from within the state was sufficient to establish nexus for Washington to impose its B&O tax on an out-of-state manufacturer. Tyler maintained no office, owned no property and had no resident employees in Washington. The solicitation of business in Washington was directed by executives whose offices were outside the State and by one in-state independent contractor.

H.R. 1956 would allow an out-of-state company to easily avoid Washington's B&O tax under the facts of *Tyler Pipe.* First, the Washington B&O tax would clearly be considered a business activity tax under H.R. 1956 Section 4(2) (A) (i), (iii) and (vi). If the independent contractor performed sales solicitation services for one additional business entity during the taxable year, Washington would be preempted from imposing its B&O tax on the company, even if Tyler Pipe utilized the services of the contractor 52 weeks per year. Section 3(b)(2).

Michigan's single business tax (SBT) would also be included in the definition of "other business tax" in Section 4(2)(A). Doing so would reverse longstanding current law. In *Gillette Company v. Michigan Department of Treasury,* 198 Mich. App. 303, 497 N.W. 2d 595 (MI Ct. App. 1993), *appeal denied,* 519 N.W. 2d 156, *reconsideration denied.* 521 N.W. 2d 612 (MI 1994), *cert. denied.* 513 U.S. 1103 (1995), the Michigan Court of Appeals ruled that Michigan's single-business tax was not a tax imposed on or measured by net income. Therefore, the tax was not included within the definition of "net income tax" set forth in PL 86-272.

H.R. 1956 Section 4(2) (A) (v) explicitly includes a single business tax within the definition of "other business activity tax" covered by the bill. As Gillette's activities in Michigan were limited to the solicitation of orders that were accepted and filled from outside the state, Section 2(a) of the bill would preempt Michigan from imposing its SBT on Gillette, thereby overruling the decision of the Michigan Court of Appeals.[18]

[18] The extension of PL 86-272 to business activity taxes other than a net income tax would have broader ramifications than merely extending the statute's protection of solicitation activity to those taxes. As the discussion of *Chattanooga Glass* makes clear in the net income tax context, extending the statute's protection to other taxes will have similar consequences for those taxes where the business engages in substantial activities that are clearly not ancillary to solicitation.

5. **H.R. 1956 would substantially preclude a state from levying a business activity tax on or as a result of a sale of an intangible.**

Section 2(a) of H.R. 1956 extends the protection of PL 86-272 to the solicitation of services or intangibles, thereby expanding the existing safe harbor for sellers of tangible personal property to the entire economy.

In *Amway Corporation, Inc. v. Missouri Director of Revenue,* 794 S.W. 2d 666 (1990), the Missouri Supreme Court held that the sale of distributorships by Amway, a Michigan corporation, exceeded the safe harbor established by PL 86-272 for the solicitation of orders for tangible personal property. The Court found a distributorship to be a license sold for a fee by Amway for "the right to service … customers and sponsor … distributors." The Court further found the sale of such a right to constitute a nonexclusive franchise the sale of which is the sale of intangible personal property. As of 1980, the last tax year at issue, Amway had more than 35,000 Missouri distributors and realized more than $175,000 in income from the sale of Amway distributorships in Missouri.

H.R. 1956 would effectively overrule *Amway* because the State would be preempted from imposing a business activity tax on the sale of distributorships.

In addition, given the physical presence requirement of Section 3(b), a number of cases that have ruled that physical presence is not required for a state to have corporate income tax nexus with a Delaware trademark holding company would be overruled if the bill were to be enacted. *Geoffrey, Inc. v. South Carolina Tax Commission,* 437 S.E. 2d 13 (S.C.), *cert. denied,* 510 U.S. 992 (1993); *A&F Trademark, Inc., et al.. v. North Carolina Secretary of Revenue,* 605 S.E. 2d 187 (NC Ct. App. 2004). The amount of "nowhere income" realized by PICs (passive investment companies) is enormous. For example, the local operating companies in *A&F Trademark* had claimed state income tax deductions of $301,067,619 in royalties and $ 122,031,344 in interest paid to PICs in 1994, accounting for 100% of the taxpayers' income for that year.

6. **H.R. 1956 arguably may preempt a state from imposing a vendor sales tax.**

H.R. 1956, Section 4(2) (B) excludes a transaction tax from the definition of "other business activity tax." But Section 4(2)(A)(i) specifically includes a tax imposed on or measured by gross receipts within the definition of "other business activity tax." In addition, Section 4(2)(A)(vi) includes within the definition of "other business activity tax" any tax imposed by a state on a business "for the right to do business in that state or measured by the amount of, or economic results of, business or related activity in that state." This creates an ambiguity as to whether a vendor sales tax is included within the definition of "other business activity tax." At the very least, this ambiguity will lead to litigation in those states that impose a gross receipts tax on a vendor for the privilege of engaging in retail sales.

Arizona imposes a privilege tax "measured by the amount or volume of business transacted .. on account of … business activity, and in the amounts to be determined by the application of rates

against values, gross proceeds of sales or gross income ...." A.R.S. §42-5008A (2004). The tax is not a direct tax upon goods one sells; rather, it is a tax directly and specifically for the privilege of conducting business within Arizona. *Arizona Department of Revenue v. Robinson's Hardware*, 149 Ariz. 589, 721 P.2d 137 (AZ Ct. App. 1986). The Arizona retail transaction privilege tax appears to come within the scope of H.R. 1956, Sections 4(2) (A) (i) and (vi). If so, H.R. 1956 would arguably overrule *Arizona Department of Revenue v. O'Connor, Cavanaugh, Anderson, Killingsworth & Beshears*, 192 Ariz. 200, 963 P. 2d 279 (AZ Ct. App. 1997).

In *O'Connor*, the Arizona Court of Appeals ruled that an Indiana manufacturer of custom office furniture had sufficient nexus with Arizona for the state to impose its retail transaction privilege tax. Between February 1985 and April 1989, Dunbar, the Indiana furniture manufacturer, entered into eighteen contracts to manufacture, sell and install office furniture for a Phoenix law firm. Dunbar employees delivered the furniture, usually in Dunbar trucks, and installed it in the Phoenix law office. In addition, Dunbar dispatched employees to Arizona on three occasions over the life of a three-year warranty to perform warranty services. On two of those occasions, Dunbar employees spent a week or more at the firm's new offices to correct the problems.

On these facts, it is likely that Dunbar's employees did not spend more than 21 days in Arizona in any taxable year. If H.R. 1956 applies to Arizona's retail transaction privilege tax, Arizona would therefore be precluded from imposing its tax under Section 3(b) (1). In any event, an out-of-state vendor could easily restructure itself so as to provide delivery and installation services through another person under Section 3(b)(2) and engage in those activities on a tax-free basis even if those persons were present in Arizona for more than 21 days in a taxable year.

Furthermore, an out-of-state vendor can maintain tangible leased property in the taxing state indefinitely without exceeding the protection of H.R. 1956, as long as that property is used to furnish a service to the owner or lessee by another person. Section 3(b)(3)(A). This would arguably overrule the holding of the Arizona Court of Appeals in *Arizona Department of Revenue v. Care Computer Systems, Inc.*, 197 Ariz. 414, 4 P.3d 469 (AZ Ct. App. 2000).

Care Computer is a Washington corporation that sells and licenses computer hardware and software to nursing homes. During the audit period, Care engaged in approximately 180 transactions with Arizona nursing homes. The vast majority of Care's Arizona transactions were conducted by mail or telefax. Two of the transactions were leases and the rest were sales. One lease was for a general ledger program; the other was for three programs and a computer. At the end of both lease terms, the lessees bought the leased goods, and Care credited 75% of the lease payments to the sales prices. Total rental payments for the two transactions were $ 24,208.86.

Care had one salesperson assigned to Arizona who operated from California. He visited Arizona on seven occasions during the audit period, averaging one- to two-day visits each time. In addition, Care conducted training for its Arizona nursing home customers on 80 widely separated days of the 1370 days covered by the audit from July 1987 through March 1991, or an average of 24 days per year.[19]

[19] The 24 day average is not broken down by taxable year. It is quite possible that Care's training personnel were not present in Arizona in excess of 21 days per taxable year.

Care charged a license fee for its leased products. Approximately $105,000 of Care's income from Arizona transactions during the audit period consisted of software licensing fees.

Based on the above facts, the Arizona Court of Appeals found sufficient nexus for Arizona to impose the retail transaction privilege tax. If H.R. 1956 were to be enacted, the continued authority of *Care Computer* would be in doubt. It would be easy enough for a company to reorganize itself such that in-state training would be performed by another person within the meaning of Section 3(b)(2). The property would then be within the safe harbor of Section 3(b)(3)(a) as it would be used to furnish a service to the lessee of the property by another person.

Conclusion

If H.R. 1956 is enacted, there is substantial reason to believe that the bill would upset settled law regarding state business activity taxation of numerous industries, including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software.

III: Preliminary Estimates of the Revenue Impact of H.R. 1956

1. Preliminary Findings:

Based on the results from the 34 responding states to date, the "best" estimate of the impact for ***all*** states in fiscal year 2007 is $6.6 billion.[20] The total effect in fiscal year 2007 is the sum of three effects, static effect, dynamic effect, and compliance effect, which are described below. Using the best estimates of state revenue agency personnel, the projected revenue impacts are: $3.0 billion; $4.2 billion; and $443 million from the static effect, the dynamic effect, and the compliance effect respectively.

The estimated total revenue impact of H.R. 1956 in fiscal year 2007 would range from $5.5 billion to $9.4 billion. The estimates of the static effect range from $2.5 billion to more than $3.5 billion; $3.0 billion is the best estimate. This relatively narrow range of the expected impact is based on the judgment of state revenue estimating personnel from their examination of business income tax returns. Conversely, the relatively wide range ($2.5 billion to $5.3 billion) of the estimated revenue impact resulting from expected changes in the response of business firms to the change in tax law – the dynamic effect – is based on state revenue agency staff projections of

[20] This estimate was derived by multiplying the estimate of the revenue impact of H.R. 1956 as a proportion of projected business activity tax revenues, as reported by the states, (14.1 percent) by the projected business activity tax revenue for all states in fiscal year 2007 – $57.7 billion. Business activity taxes are defined as: corporate franchise taxes, corporate income taxes, and Business and Occupation Taxes (Washington State), Single Business Tax (Michigan) and Use Tax in Illinois. These taxes were chosen to represent all business activity taxes because they were the ones estimated by the responding states. A more detailed explanation of how the weighted average was obtained is presented in the APPENDIX.

The estimates for U.S. business activity tax collections in 2007 were derived by projecting business activity tax revenues for fiscal years 1999, 2000, 2001, 2002 and 2003 through 2007 using straight line trends and growth trends and averaging those results. Data for state business activity taxes are from the U.S. Bureau of the Census, ***State Tax Collections*** for the various years.

business responses to H.R. 1956. The range of estimates of the compliance effect (approximately $418 million to approximately $445 million) is based on current enforcement actions that would not be taken if H.R. 1956 were to become law.[21]

State revenue agency personnel were asked to estimate the revenue impact of H.R. 1956 on their state's revenue in fiscal year 2007 and beyond. Fiscal year 2007 was chosen as the target year because it was assumed that, if enacted, H.R. 1956 would be in effect for fiscal years 2005 and beyond; and, that the revenue effects would not be significant until two years after the law was enacted. This time frame was considered sufficient for business firms to reorganize their operations in order to take advantage of the protections offered by H.R. 1956 to reduce their state business activity tax liabilities. However, preliminary responses from some states indicate that the revenue impact could increase significantly for fiscal years 2009 and beyond. For example, seven states, California, Delaware, Kentucky, New Jersey, Tennessee, Washington, and Wisconsin, provided estimates of the revenue impact for fiscal year 2009 as well as 2007. Using those states' "best" estimates, the total revenue impact for those states would increase from $1.8 billion to $2.5 billion – or 40.5 percent.

2. **Methods of Estimation:**

Revenue estimators projected the revenue impact of H.R. 1956 on their state by assuming that the impact would result from three simultaneously occurring effects:

- (*Static Effect*): Businesses that would no longer be subject to tax by the revenue estimator's state or localities under the new law because their physical presence in a state was below the threshold established by H.R. 1956 (21 days or fewer for property or personnel to be in a state); or, the firms engage in one of the protected activities.
- (*Dynamic Effect*): Businesses would, in response to the planning opportunities created by federal law, restructure or otherwise engage in tax planning to minimize their tax liability in the revenue estimator's state.
- (*Compliance Effect*): The loss of revenue that states had expected to gain from current enforcement activities with respect to non-complying businesses under current law, but which states would be barred from collecting because the federal law would bar further enforcement.

3. **Explanation and Examples of Effects:**

a) Static Effect – Estimating the Loss of Currently Collected Revenues

States can experience some immediate reduction in business activity tax revenue because some businesses that have no physical presence, or only minor physical presence. For example, businesses that may be seasonal or transient in nature, but are currently filing and remitting business activity taxes, will no longer be subject to business activity taxes because their level of

[21] The sum of the static effect, dynamic effect, and compliance effect will not add to the total effect because a few states provided estimates of the total effect only. No effort was made to allocate the total effect to each of the separate effects.

physical presence is below the level established by H.R. 1956 (21 days). Similarly, some businesses would be protected by the special protections offered by H.R. 1956, for example, their only physical presence is property being processed by a contract manufacturer, or their activity is limited to covering events for the media.

Estimates of the static effect were based on the assumption that those businesses that are currently remitting business activity taxes but have $0 or *de minimis* amounts of either property or payroll in the taxing state would not be subject to that state's business activity taxes. Revenue estimators used the dollar amounts of payroll or property in their state to estimate the impact of H.R. 1956 rather than the number of days each business had personnel or property in their state because the tax returns, and tax liabilities are based on the relative dollar levels of those factors. The de *minimis* level of the factors used to estimate the revenue impact is usually stated on the state response sheet. Not all states responding to the survey explicitly stated the level of payroll or property on which their estimate was based.

b) Dynamic Effect – Estimating the Loss of Revenues from Business Tax Planning Permitted by H.R. 1956

One example of the dynamic effect of H.R. 1956 is a company setting up an affiliate for marketing in a state. That affiliate would have a permanent physical presence in the state. The company could also establish two wholesale or producer affiliates corresponding to different product lines of the company, both serviced by the marketing affiliate and neither having a physical presence in a state. While the marketing affiliate would have a presence in the state, the rest of the business or corporate structure would not be subject to business activity taxes. Transfer prices could be set so as to minimize the tax paid by the marketing affiliate. Alternatively, the marketing representative in a state might be an independent contractor, with the same result of exempting from tax the company that has set up the two affiliates corresponding to more than one product line. The independent contractor would be taxable, but the corporation whose products are being sold would not be.

Another, but somewhat more complex, example involves an out-of-state holding company that operates a number of stores in a state. The holding company could establish a management company remote from the states in which the stores are located. Similarly, the holding company could establish a staffing company that leases employees to the operating units (stores). Income could be shifted out of the state in which the stores operate by paying a "management fee" to the management company. The staffing company would also pay a fee to the management company further siphoning income from the state in which the stores operate. Furthermore, senior managers from the management company can work in the state with the operating company for fewer than 21 days without creating nexus for the management company.

H.R. 1956 can also negatively affect future revenues of state and local gross receipts, gross profits, or similar taxes. A business can reorganize in such a way to source sales into a state through entities that do not have nexus and thus are exempt from taxation in that state. All other activities that create and maintain the market in the market states that go beyond the protections provided by H.R. 1956 can be placed into separate entities. For example, a business can set up a wholesale or distribution subsidiary outside of the jurisdiction of the market state. By selling to

independent contract marketers, as defined by H.R. 1956, in the market state, and through careful transfer pricing, the business can minimize its gross receipts tax liability in the market state.

There are other, more complex transactions and reorganizations that are available to many business firms. Because of the complexity of the dynamic effect, projecting the dynamic revenue impact estimates is a difficult process. This process requires revenue estimators to project the level of business activity taxes in the absence of H.R. 1956; and then to project how business taxpayers will respond to the new law.

An exposition of how multistate businesses can rearrange their organizations to take advantage of some of the provisions of legislation such as H.R. 1956 was presented by Joe Garrett of the Alabama Department of Revenue at MTC's 2004 Annual Meeting: http://www.mtc.gov/2004AnnualConferenceAgenda_files/Garrett.pdf.

c) Compliance Effect – Estimating the Loss of Anticipated Revenues from Compliance Activities that Would Be Blocked by H.R. 1956

Revenue estimators were asked to project the loss of future revenues from current enforcement efforts that would be blocked by H.R. 1956. These lost revenues would be in addition to the revenues lost from both the static and dynamic effects noted previously. For example, the estimator may project how much revenue the revenue estimator's state would lose in anticipated future revenue from enforcing a ruling in which the state court denied the tax effects of the use of intangible holding companies.

The compliance effect involves estimating revenues that are not yet in currently collected revenues, but are expected to be collected due to what the state considers to be sound compliance efforts. H.R. 1956 may result in legalizing activities that the revenue estimator's enforcement branch considers to be improper under current law and are now seeking to enforce. In these cases, H.R. 1956 will produce a loss of anticipated, but as yet not collected revenues.

4. State by State Estimates:

The respondent states were grouped into three categories: combined reporting states[22], separate entity states,[23] and special. Michigan and Washington State comprise the special category because their primary business activity taxes are the Single Business Tax and the Business and Occupation Tax respectively. For the percentage impact, the responses of the combined reporting states were added and that sum was divided by the sum of the corresponding responses for the estimated business activity taxes. As shown in Table 2 below, the minimum expected revenue impact of H.R. 1956 for the respondent states, as a percent of expected business activity tax revenue in 2007 is 7.6 percent. For combined reporting states, the expected impact is 2.3

[22] The combined reporting states are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. Combined reporting is a state tax accounting in which the taxable income of a single or unitary business operating in several states is apportioned among the states. The taxable income of the separate legal entities is added together.

[23] In separate entity states, the taxable income of each legal entity is apportioned among the states in which it operates.

percent, for separate entity states the expected impact is 11.0 percent, and for the special states, the impact is 14.4 percent.

Table 2
Estimate of Revenue Impact of H.R. 1956 on Respondent States:
Fiscal Year 2007

Type of State	Minimum Impact	Best Estimate	Maximum Impact	Minimum Impact	Best Estimate	Maximum Impact
	(millions)			(Percent of Business Activity Tax)		
All States	$3,300.2	$4,558.3	$5,534.2	7.6%	10.4%	12.7%
Combined Reporting	443.6	523.0	608.6	2.3	2.7	3.2
Separate Entity	2,044.9	2,929.2	3,525.4	11.0	15.7	18.9
Special States (MI & WA)	811.6	1,106.1	1,400.2	14.4	19.6	24.8

Table 3 below presents estimates of the total revenue impact on states of H.R. 1956 in fiscal year 2007. National estimates were derived by assuming that each of the non-responding states would be affected by H.R. 1956 to the same extent as states that have similar tax structures. Thus, the estimates for each of the non-respondent combined reporting states were obtained by multiplying their estimated business activity tax revenue in 2007 by the respective percentage estimates -- 2.3 percent for the minimum impact, 2.9 percent for the "best" estimate, and 3.4 percent for the maximum expected impact. A similar procedure was performed on the non-respondent separate entity states.

The estimates for non-respondent states were then added to the estimates provided by the respondent states to obtain a national estimate. The higher percent estimates for the United States (13.5% best estimate) relative to respondent states (11.4% best estimate) is due to the over-representation of combined reporting states among the responding states. State-by-state estimates of each of the separate effects (static, dynamic, and compliance, and total effect) for fiscal year 2007 are contained in APPENDIX Tables A, B, and C. Table A contains estimates of the minimum impact H.R. 1956 would have on states, Table B is the "best" estimate, and Table C contains estimates of the maximum impact of H.R. 1956.

5. Notes on the Preliminary Estimates

The estimates of the revenue impact of H.R. 1956 do not take into account some states use a "throwback" rule or a "throwout" rule to minimize "nowhere" income.[24] The "throwback" rule affects the sales factor of the apportionment formula when sales are made by a seller into a state which has no jurisdiction to impose an income tax on the seller. Those sales are assigned back to the state from which the goods sold have been shipped. The "throwout" rule is similar to the "throwback" rule – sales into states that do not have authority to impose an income tax on the seller are removed from both the numerator and denominator of the sales factor of the apportionment formula.

[24] Income that is not sourced to any state. This can occur when a seller of tangible personal property has no nexus in a destination state, or a state is limited by the U.S. Constitution or statute from imposing a tax.

Also, the estimates of the revenue impact of H.R. 1956 are just that, estimates. Any imprecision of the estimates arise from the need to anticipate how those affected by the legislation will react. As George Yin, Chief of Staff of the Joint Committee on Taxation, stated at a conference in Los Angeles on March 1, 2004 regarding the Joint Committee's staff estimates of the revenue impact of federal legislation:

> "… it's certainly a very imprecise process. There is some science involved in it and clearly some art involved in it -- no question about it." [25]

Despite the presence of "throwback" or "throwout" rules, and the imprecision of making these types of estimates, it is clear that, should H.R. 1956 be passed into law, there would be a significant revenue impact on state and local governments.

TABLE 3
Estimated Revenue Impact of H.R. 1956 by State
Fiscal Year 2007

State	Estimated Revenue Impact of H.R. 3220: Fiscal Year 2007[1]			Estimated Business Activity Tax Revenue F.Y. 2007[2]	Revenue Impact as Percent of Business Activity Tax Revenue		
	Minimum Impact	Best Estimate of Impact	Maximum Impact		Minimum Impact	Best Estimate of Impact	Maximum Impact
	(millions)				(Percent)		
United States	***$4,718.6***	***$6,588.3***	***$7,968.1***	***$57,693.8***	***8.2%***	***11.4%***	***13.8%***
Alaska	5.1	5.1	5.1	505.0	1.0	1.0	1.0
Arkansas	63.0	92.5	96.0	256.0	24.6	36.1	37.5
California	150.0	150.0	150.0	7,344.0	2.0	2.0	2.0
Connecticut	101.9	119.4	136.8	381.7	26.7	31.3	35.8
Delaware	22.0	30.5	30.5	298.1	7.4	10.2	13.1
Georgia	30.9	30.9	30.9	511.2	6.0	6.0	6.0
Idaho	8.0	8.0	*8.0*	*1,009.1*	0.8	0.8	0.8
Illinois	91.0	91.0	91.0	8,564.3	1.1	1.1	1.1
Iowa	45.0	46.0	46.0	200.0	22.5	23.0	23.5
Kansas	31.2	31.2	31.2	286.1	10.9	10.9	10.9
Kentucky	125.2	212.4	259.3	593.4	21.1	35.8	43.7
Maryland	106.4	106.4	106.4	397.0	26.8	26.8	26.8
Massachusetts	91.0	137.0	183.0	1,572.0	5.8	8.7	11.6
Michigan	417.5	417.5	417.5	2,113.3	19.8	19.8	19.8
Minnesota	47.1	54.4	67.1	621.5	7.6	8.8	10.8
Missouri	173.6	173.6	173.6	437.1	39.7	39.7	39.7

[25] Kenneth A. Gary, "Yin Explains JCT Revenue Estimating Efforts," ***Tax Notes***, Tax Analyst, Inc., TNT 42-6, Arlington, VA, March 2, 2004.

TABLE 3
Estimated Revenue Impact of H.R. 1956 by State
Fiscal Year 2007

State	Estimated Revenue Impact of H.R. 3220: Fiscal Year 2007[1]			Estimated Business Activity Tax Revenue F.Y. 2007[2]	Revenue Impact as Percent of Business Activity Tax Revenue		
	Minimum Impact	Best Estimate of Impact	Maximum Impact		Minimum Impact	Best Estimate of Impact	Maximum Impact
	(millions)				(Percent)		
Montana	3.0	4.5	6.0	79.2	3.8	5.7	7.6
New Hampshire	58.4	58.4	58.4	281.0	20.8	20.8	20.8
New Jersey	398.3	398.3	398.3	2,791.0	14.3	14.3	14.3
North Carolina	58.5	345.5	345.5	1,352.5	4.3	25.5	34.8
North Dakota	3.5	5.2	6.8	46.0	7.6	11.2	14.8
Ohio	171.0	298.0	425.0	1,022.0	16.7	29.2	41.6
Oklahoma	31.8	31.8	31.8	172.0	18.5	18.5	18.5
Oregon	35.3	90.7	179.2	314.7	13.7	35.1	55.4
Pennsylvania	51.5	77.8	92.6	3,928.0	1.3	2.0	2.4
South Dakota	6.5	6.5	6.5	94.3	6.9	6.9	6.9
Tennessee	191.1	234.8	294.9	1,457.3	13.1	16.1	20.2
Texas	225.0	410.0	530.5	2,000.0	11.3	20.5	26.5
Utah	2.8	3.9	5.8	260.0	1.1	1.5	2.2
Virginia	0.0	0.0	0.0	420.2	0.0	0.0	0.0
Washington	394.1	688.6	982.7	3,543.8	11.1	19.4	27.7
West Virginia	102.2	127.8	153.3	199.8	51.2	64.0	76.7
Wisconsin	50.0	50.0	50.0	577.0	8.7	8.7	8.7
Other combined reporting states	32.6	38.5	49.5	1421.7	2.3	2.7	3.2
Other separate entity states	1385.7	1984.3	2592.1	12660.2	11.0	15.7	18.9

1. Data in italics were estimated by the Multistate Tax Commission.

2. Includes Corporate income taxes, corporate franchise taxes, Single Business Tax (MI), Business and Occupation Tax (WA), Use Tax, (IL) and Public utility gross receipts taxes

3. Other combined reporting states: Arizona, Colorado, Hawaii, Maine, Nebraska, Vermont.
4. Other separate entity states: Alabama, D.C., Florida, Indiana, Louisiana, Mississippi, Nevada, New Mexico, New York, Rhode Island, South Carolina, Wyoming.

Source: APPENDIX Tables 1A, 1B, and 1C.

TABLE 3
Estimated Revenue Impact of H.R. 1956 by State
Fiscal Year 2007

State	Estimated Revenue Impact of H.R. 3220: Fiscal Year 2007[1]			Estimated Business Activity Tax Revenue F.Y. 2007[2]	Revenue Impact as Percent of Business Activity Tax Revenue		
	Minimum Impact	Best Estimate of Impact	Maximum Impact		Minimum Impact	Best Estimate of Impact	Maximum Impact
	(millions)				(Percent)		

IV: Summary and Conclusion

The sponsors of H.R. 1956 assert that this proposed legislation would establish clear rules regarding state and local government authority to impose business activity taxes on businesses engaged in interstate commerce. According to the proponents of this legislation, such clarity would bring certainty for businesses regarding their potential tax liabilities when making business investment decisions. Reduction of uncertainty would, in the opinion of the sponsors, lead to greater investment and job growth. Similarly, the sponsors assert that states would benefit from greater certainty regarding their authority to impose business activity taxes on firms engaged in interstate commerce. One beneficial outcome of this legislation, in the opinion of the proponents of this legislation, would be reduced litigation over nexus.

However, as shown in section II of this report, responses by state revenue agency legal staffs show that they are uncertain as to how their statutes and regulations relating to their "doing business" standards would mesh with H.R. 1956. This uncertainty could result in *more* litigation regarding state authority to impose business activity taxes.

The "bright line" test, proposed by the sponsors of this legislation, for determining whether a state has the authority to impose its business activity tax on a firm is based on a concept of physical presence – property or personnel in a state for 21 days or more. A physical presence test for state and local authority to impose business activity taxes would result in non-neutrality in the tax treatment of local businesses relative to businesses without the minimum level of physical presence for nexus. Long-term trends show that the economy is becoming more service oriented and less oriented toward manufacturing and mercantile activities. Physical presence, however measured, is becoming less important for the delivery of services and intangibles. Thus, if business activity taxes are to tax income in a reasonable approximation where the income is earned, physical presence is essentially irrelevant. Furthermore, technological innovations such as the Internet allow merchants to sell their products and services anywhere without a physical presence in many of the locations in which they do business. Local businesses would be at a tax disadvantage relative to remote firms as they compete for the same market.

Some may argue that local business receives a greater level of benefits from local governments and thus should bear higher taxes. A valid counterargument is that the benefits of local government that benefit businesses directly – public infrastructure, and fire and police protection -- are paid by businesses primarily through taxes on the value of business property and on use taxes on their purchases of inputs. These taxes are imposed only on local businesses.

In addition, this physical presence standard may create more record keeping for companies as they must be cognizant of when their property or personnel cross the physical presence standard. State revenue agencies would also need to have access to those records in order to determine whether a firm meets the physical presence test. This is an added cost for both the business sector and revenue agencies.

Finally, H.R. 1956 would have a significant adverse revenue impact on state governments – between $4.7 billion and $8.0 billion in 2007 – at a time when state and local governments are faced with rising costs of Medicaid, homeland security, and education. State and local

governments would be forced to increase other taxes, decrease expenditures, or find combinations of tax increases and expenditure cuts to make up for lost revenues.

In conclusion, enactment of H.R. 1956 into law would not necessarily result in greater certainty for businesses and states but could create more confusion and litigation regarding state authority to impose business activity taxes. In addition, the bill create would artificial barriers to the most efficient locations of investment and employment resulting in lower rates of economic growth, and impose significant fiscal costs on state and local government.

APPENDIX

Estimates of Business Activity Tax Revenue for Non-Respondent States, Fiscal Year 2007

As noted in the text, estimates of the revenue impact for the non-respondent states were derived by multiplying the estimated revenue impact of the static effect as a proportion of business activity tax revenue, the estimated revenue impact of the dynamic effect as a proportion of business activity tax revenue, the estimated revenue impact of the compliance effect as a proportion of business activity tax revenue, and the estimated revenue impact of the total effect as a proportion of business activity tax revenue of the respondent states. The respondent and non-respondent states were classified as combined reporting states, separate entity states, and "special states (WA & MI). The estimated revenue impact for each non-respondent separate entity state was derived by dividing each of the revenue impacts (static effect, dynamic effect, compliance effect, and total impact) of all respondent separate entity states by the sum of the business activity tax revenue for those states (see Table 1) and multiplying by the estimated business activity tax revenue of the non-respondent state. The same estimating procedure was used to estimate the revenue impact for non-responding combined reporting states. In mathematical notation, for a non-respondent separate entity state, the static effect is:

$$\mathbf{S_{nri} = \{\Sigma S_{ri}/\Sigma BAT_{ri}\} * BAT_{nri}}$$

Where: $\mathbf{S_{nri}}$ is the static effect in nonrespondent state, i

$\mathbf{\Sigma S_{ri}}$ is the sum of the static revenue impact of the respondent states

$\mathbf{\Sigma BAT_{ri}}$ is the sum of business activity tax revenue of the respondent states and

$\mathbf{BAT_{nri}}$ is the estimate business activity tax revenue for nonrespondent state i.

The procedure is repeated to estimate the dynamic impact, compliance impact, and total impact separately. The same procedures were used to estimate the revenue impacts on combined reporting states.

The estimated business activity tax revenue (BAT) for nonrespondent state (i) was derived by dividing each nonrespondent state's BAT in 2003 by the sum of the 2003 BAT for all nonrespondent states. The quotient was then multiplied by the difference between the estimated total BAT in fiscal year 2007 ($57.7 billion) and the sum of the BAT in 2007 of the respondent states ($43.6 billion). The difference between the BAT sums is $14.1 billion. Again, in mathematical notation the estimated 2007 BAT for a nonrespondent state is:

$$\mathbf{BAT_{nri} = (BAT2003_{nri}/\Sigma BAT2003_{nri}) * \$14.1\ billion}$$

Where:

$\mathbf{BAT_{nri}}$ is estimated business activity tax revenue of nonrespondent state (i) in 2007

$\mathbf{BAT2003_{nri}}$ is business activity tax revenue of nonrespondent state (i) in 2003

$\mathbf{\Sigma BAT2003_{nri}}$ is the sum of fiscal year 2003 business activity tax revenues of all nonrespondent states.

Appendix TABLE1A
Estimated Revenue Impact of H.R. 1956 by State: Minimum Impact
Fiscal Year 2007
Dollar Amounts in Millions

State	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
				(1)+(2)+(3)		(4)/(5)
*United States**	*$2,126.7*	*$2,124.4*	*$364.7*	*$4,718.6*	*$57,693.8*	*8.2%*
Responding States	$1,456.9	$1,507.6	$252.3	$3,300.26	$43,628.5	7.6%
Alaska[2]	5.1	n.r	n.r	5.1	505.0	1.0
Arkansas[3]	6.0	57.0	n.r.	63.0	256.0	24.6
California [4,5]	n.r	150.0	n.r.	150.0	7,344.0	2.0
Connecticut[6]	75.2	26.8	n.r.	101.9	381.7	26.7
Delaware[7]	n.r.	n.r.	n.r.	22.0	298.1	7.4
Georgia[8]	30.9	n.r.	n.r.	30.9	511.2	6.0
Idaho[4]	8.0	n.r.	n.r.	8.0	*1,009.1*	0.8
Illinois[9]	91.0	n.r.	n.r.	91.0	8,564.3	1.1
Iowa[4]	10.0	30.0	5.0	45.0	200.0	22.5
Kansas[8]	2.2	29.3	n.r.	31.5	218.5	14.4
Kentucky[10]	39.1	86.1	n.r.	125.2	593.4	21.1
Maryland[11]	66.7	39.7	n.r.	106.4	397.0	26.8
Massachusetts[12]	91.0	n.r.	n.r.	91.0	1,572.0	5.8
Michigan[13]	239.1	150.9	27.5	417.5	2,113.3	19.8
Minnesota[4]	30.0	7.5	9.7	47.1	621.5	7.6
Missouri[8]	173.6	n.r.	n.r.	173.6	437.1	39.7
Montana[4,14]	n.r.	n.r.	n.r.	3.0	79.2	3.8
New Hampshire[15]	n.r	n.r	n.r	58.4	281.0	20.8
New Jersey[16]	219.0	150.0	29.3	398.3	2,791.0	14.3
North Carolina[17]	8.5	50.0	n.r.	58.5	1,352.5	4.3
North Dakota[18]	3.3	n.r.	0.2	3.5	46.0	7.6
Ohio[19]	40.0	131.0	n.r.	171.0	1,022.0	16.7
Oklahoma[4,20]	3.2	28.6	n.r.	31.8	172.0	18.5
Oregon[21]	5.7	33.2	4.6	43.5	314.7	13.7
Pennsylvania	51.5	n.r	n.r	51.5	3,928.0	1.3
South Dakota[22]	0.1	6.4	n.r.	6.5	94.3	6.9
Tennessee[23]	46.0	145.1	n.r.	191.1	1,457.3	13.1
Texas[24]	25.0	70.0	130.0	225.0	2,000.0	11.3
Utah[3]	0.7	1.7	0.4	2.8	260.0	1.1
Virginia[25]	0.0	0.0	0.0	0.0	420.2	0.0

Appendix TABLE1A

Estimated Revenue Impact of H.R. 1956 by State: Minimum Impact

Fiscal Year 2007

Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
Washington[26]	96.2	252.3	45.6	394.1	3,543.8	11.1
West Virginia[4]	56.4	45.8	n.r.	102.2	199.8	51.2
Wisconsin	30.0	45.8	n.r.	50.0	577.0	8.7
Other combined reporting states	11.0	15.9	1.0	32.6	1421.7	2.3
Other separate entity states	735.5	612.6	122.4.	1470.5	12660	11.0

* Estimate of revenue impact of H.R. 3220 on all states based on state responses to survey.

Data in italics estimated by Multistate Tax Commission.

n.r. Not reported separately.

1. Excluding effects of H.R. 3220.
2. Corporate income and Fish Landing taxes.
3. Corporate income taxes only.
4. Corporate income and franchise taxes only. BAT revenue for 2007 in CA estimated by MTC.
5. Business Activity Tax for 2007 estimated by Multistate Tax Commission.
6. Includes Corporation Business Tax and Business Entity Tax.
7. Includes corporation income tax and gross receipts tax.
8. Includes Income Tax, franchise tax, and financial institutions tax. Georgia estimates are for 2003 only.
9. Includes Corporate Income and Replacement Tax, Use Tax, and Telecommunications Taxes."
10. Includes Corporate Income Tax, Corporate Franchise Tax, Bank Franchise Tax, Cigarette Taxes and fees, and Alcoholic Beverage Taxes.
11. Corporate income tax only. Assumes dynamic effect of H.R. 3220 would be 10 percent of estimated 2007 corporate income tax revenues.
12. Fiscal year 2006. Includes General business corporations tax, and financial institutions tax.
13. Single Business Tax only.
14. Midpoints of estimated range of impacts. BAT revenue for 2007 estimated by the Multistate Tax. Commission.
15. Includes Business Profits Tax, Business Enterprise Tax, and Communications Excise Tax. Estimates based on analysis of H.R. 2526, July 2002.
16. Includes corporate net income tax and Alternative Minimum Tax.
17. Includes corporate income, franchise, and personal income taxes.
18. Corporate income taxes and gross receipts taxes on telecommunications.
19. Corporate income (franchise) tax, tax on dealers of intangibles, and pass-through entities.
20. Estimates of compliance effect included in static effect estimates.

Appendix TABLE1A						
Estimated Revenue Impact of H.R. 1956 by State: Minimum Impact						
Fiscal Year 2007						
Dollar Amounts in Millions						
	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
21. State only. Corporate income and excise taxes only.						
22.Bank Tax only						
23. Includes Excise & Franchise Tax, Local Business Tax, and Professional Privilege Tax.						
24. Corporate Franchise Tax only.						
25. Reported only minor revenue impact because physical presence is nexus standard.						
26. State and local Business & Occupation Tax and State and local Public Utility Taxes.						

Appendix TABLE 1B
Estimated Revenue Impact of H.R. 1956 by State: Best Estimates
Fiscal Year 2007
Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
United States*	*$2,639.4*	*$3,463.4*	*$366.7*	*$6,588.3*	*$57,693.8*	*11.4%*
Responding States	$1,782.3	$2,429.3	$253.3	$4,558.3	$43,628.5	11.4%
Alaska[2]	5.1	n.r	n.r	5.1	505.0	1.0
Arkansas[3]	9.5	83.0	n.r.	92.5	256.0	36.1
California [4,5]	n.r	150.0	n.r.	150.0	7,344.0	2.0
Connecticut[6]	88.1	31.2	n.r.	119.4	381.7	31.3
Delaware[7]	n.r.	n.r.	n.r.	30.5	298.1	10.2
Georgia[8]	30.9	n.r.	n.r.	30.9	511.2	6.0
Idaho[4]	8.0	n.r.	n.r.	8.0	*1,009.1*	0.8
Illinois[9]	91.0	n.r.	n.r.	91.0	8,564.3	1.1
Iowa[4]	10.0	30.0	6.0	46.0	200.0	23.0
Kansas[8]	4.4	58.6	n.r.	63.0	218.5	28.8
Kentucky[10]	65.7	146.7	n.r.	212.4	593.4	35.8
Maryland[11]	66.7	39.7	n.r.	106.4	397.0	26.8
Massachusetts[12]	137.0	n.r.	n.r.	137.0	1,572.0	8.7
Michigan[13]	239.1	150.9	27.5	417.5	2,113.3	19.8
Minnesota[4]	37.3	7.5	9.7	54.4	621.5	8.8
Missouri[8]	173.6	n.r.	n.r.	173.6	437.1	39.7
Montana[4,14]	n.r.	n.r.	n.r.	4.5	79.2	5.7
New Hampshire[15]	n.r	n.r	n.r	58.4	281.0	20.8
New Jersey[16]	219.0	150.0	29.3	398.3	2,791.0	14.3
North Carolina[17]	8.5	337.0	n.r.	345.5	1,352.5	25.5
North Dakota[18]	5.0	n.r.	0.2	5.2	46.0	11.2
Ohio[19]	40.0	258.0	n.r.	298.0	1,022.0	29.2
Oklahoma[4,20]	3.2	28.6	n.r.	31.8	172.0	18.5
Oregon[21]	8.2	98.6	4.6	90.7	314.7	35.1
Pennsylvania	77.8	n.r.	n.r.	77.8	3,928.0	2.0
South Dakota[22]	0.1	6.4	n.r.	6.5	94.3	6.9
Tennessee[23]	55.7	179.1	n.r.	234.8	1,457.3	16.1
Texas[24]	155.0	125.0	130.0	410.0	2,000.0	20.5
Utah[3]	1.5	2.0	0.4	3.9	260.0	1.5
Virginia[25]	0.0	0.0	0.0	0.0	420.2	0.0

Appendix TABLE 1B

Estimated Revenue Impact of H.R. 1956 by State: Best Estimates

Fiscal Year 2007

Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
Washington[26]	138.4	504.6	45.6	688.6	3,543.8	19.4
West Virginia[4]	72.3	55.5	n.r.	127.8	199.8	64.0
Wisconsin	30.0	20.0	n.r.	50.0	577.0	8.7
Other combined reporting states	*11.7*	*21*	*1*	*33.7*	1421.7	*2.7*
Other separate entity states	*842.6*	*1009.9*	*112.2*	*1964.7*	12660	*15.7*

* Estimate of revenue impact of H.R. 3220 on all states based on state responses to survey.

Data in italics estimated by Multistate Tax Commission.

n.r. Not reported separately.

1. Excluding effects of H.R. 3220.
2. Corporate income and Fish Landing taxes.
3. Corporate income taxes only.
4. Corporate income and franchise taxes only. BAT revenue for 2007 in CA estimated by MTC.
5. Business Activity Tax for 2007 estimated by Multistate Tax Commission.
6. Includes Corporation Business Tax and Business Entity Tax.
7. Includes corporation income tax and gross receipts tax.
8. Includes Income Tax, franchise tax, and financial institutions tax. Georgia estimates are for 2003 only.
9. Includes Corporate Income and Replacement Tax, Use Tax, and Telecommunications Taxes."
10. Includes Corporate Income Tax, Corporate Franchise Tax, Bank Franchise Tax, Cigarette Taxes and fees, and Alcoholic Beverage Taxes.
11. Corporate income tax only. Assumes dynamic effect of H.R. 3220 would be 10 percent of estimated 2007 corporate income tax revenues.
12. Fiscal year 2006. Includes General business corporations tax, and financial institutions tax.
13. Single Business Tax only.
14. Midpoints of estimated range of impacts. BAT revenue for 2007 estimated by the Multistate Tax. Commission.
15. Includes Business Profits Tax, Business Enterprise Tax, and Communications Excise Tax. Estimates based on analysis of H.R. 2526, July 2002.
16. Includes corporate net income tax and Alternative Minimum Tax.
17. Includes corporate income, franchise, and personal income taxes.
18. Corporate income taxes and gross receipts taxes on telecommunications.
19. Corporate income (franchise) tax, tax on dealers of intangibles, and pass-through entities.

Appendix TABLE 1B						
Estimated Revenue Impact of H.R. 1956 by State: Best Estimates						
Fiscal Year 2007						
Dollar Amounts in Millions						
	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
20. Estimates of compliance effect included in static effect estimates.						
21. State only. Includes corporate income and excise taxes only.						
22.Bank Tax only						
23. Includes Excise & Franchise Tax, Local Business Tax, and Professional Privilege Tax.						
24. Corporate Franchise Tax only.						
25. Reported only minor revenue impact because physical presence is nexus standard.						
26. State and local Business & Occupation Tax and State and local Public Utility Taxes.						

Appendix TABLE 1C
Estimated Revenue Impact of H.R. 1956 by State: Maximum Impact
Fiscal Year 2007
Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
*United States**	*$3,061.5*	*$4,403.9*	*$368.1*	*$7,968.1*	*$57,693.8*	*13.8%*
Responding States	$2,060.9	$3,115.6	$254.3	$5,534.2	$43,628.5	12.7%
Alaska[2]	5.1	n.r	n.r	5.1	505.0	1.0
Arkansas[3]	12.0	84.0	n.r.	96.0	256.0	37.5
California [4,5]	n.r	150.0	n.r.	150.0	7,344.0	2.0
Connecticut[6]	101.1	35.7	n.r.	136.8	381.7	35.8
Delaware[7]	n.r.	n.r.	n.r.	30.5	298.1	13.1
Georgia[8]	30.9	n.r.	n.r.	30.9	511.2	6.0
Idaho[4]	8.0	n.r.	n.r.	8.0	1,009.1	0.8
Illinois[9]	91.0	n.r.	n.r.	91.0	8,564.3	1.1
Iowa[4]	10.0	30.0	6.0	46.0	200.0	23.5
Kansas[8]	5.7	25.5	n.r.	31.2	286.1	10.9
Kentucky[10]	80.6	178.7	n.r.	259.3	593.4	43.7
Maryland[11]	66.7	39.7	n.r.	106.4	397.0	26.8
Massachusetts[12]	183.0	n.r.	n.r.	183.0	1,572.0	11.6
Michigan[13]	239.1	150.9	27.5	417.5	2,113.3	19.8
Minnesota[4]	50.0	7.5	9.7	67.1	621.5	10.8
Missouri[8]	173.6	n.r.	n.r.	173.6	437.1	39.7
Montana[4,14]	n.r.	n.r.	n.r.	6.0	79.2	7.6
New Hampshire[15]	n.r	n.r	n.r	58.4	281.0	20.8
New Jersey[16]	219.0	150.0	29.3	398.3	2,791.0	14.3
North Carolina[17]	8.5	337.0	n.r.	345.5	1,352.5	34.8
North Dakota[18]	6.6	n.r.	0.2	6.8	46.0	14.8
Ohio[19]	40.0	385.0	n.r.	425.0	1,022.0	41.6
Oklahoma[4,20]	3.2	28.6	n.r.	31.8	172.0	18.5
Oregon[21]	14.0	160.5	4.6	179.2	314.7	55.4
Pennsylvania	92.6	n.r.	n.r.	92.6	3,928.0	2.4
South Dakota[22]	0.1	6.4	n.r.	6.5	94.3	6.9
Tennessee[23]	62.3	232.6	n.r.	294.9	1,457.3	20.2
Texas[24]	255.0	145.5	130.0	530.5	2,000.0	26.5
Utah[3]	2.4	3.0	0.4	5.8	260.0	2.2
Virginia[25]	0.0	0.0	0.0	0.0	420.2	0.0
Washington[26]	182.2	754.9	45.6	982.7	3,543.8	27.7

Appendix TABLE 1C

Estimated Revenue Impact of H.R. 1956 by State: Maximum Impact

Fiscal Year 2007

Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
West Virginia[4]	88.1	65.2	n.r.	153.3	199.8	76.7
Wisconsin	30.0	20.0	n.r.	50.0	577.0	8.7
Other combined reporting states	*13.3*	*35.4*	*1*	*49.7*	1421.7	*3.2*
Other separate entity states	*989.8*	*1267.4*	*113.1*	*2370.3*	12660	*18.9*

* Estimate of revenue impact of H.R. 3220 on all states based on state responses to survey.

Data in italics estimated by Multistate Tax Commission.

n.r. Not reported separately.

1. Excluding effects of H.R. 3220.
2. Corporate income and Fish Landing taxes.
3. Corporate income taxes only.
4. Corporate income and franchise taxes only. BAT revenue for 2007 in CA estimated by MTC.
5. Business Activity Tax for 2007 estimated by Multistate Tax Commission.
6. Includes Corporation Business Tax and Business Entity Tax.
7. Includes corporation income tax and gross receipts tax.
8. Includes Income Tax, franchise tax, and financial institutions tax. Georgia estimates are for 2003 only.
9. Includes Corporate Income and Replacement Tax, Use Tax, and Telecommunications Taxes."
10. Includes Corporate Income Tax, Corporate Franchise Tax, Bank Franchise Tax, Cigarette Taxes and fees, and Alcoholic Beverage Taxes.
11. Corporate income tax only. Assumes dynamic effect of H.R. 3220 would be 10 percent of estimated 2007 corporate income tax revenues.
12. Fiscal year 2006. Includes General business corporations tax, and financial institutions tax.
13. Single Business Tax only.
14. Midpoints of estimated range of impacts. BAT revenue for 2007 estimated by the Multistate Tax. Commission.
15. Includes Business Profits Tax, Business Enterprise Tax, and Communications Excise Tax. Estimates based on analysis of H.R. 2526, July 2002.
16. Includes corporate net income tax and Alternative Minimum Tax.
17. Includes corporate income, franchise, and personal income taxes.
18. Corporate income taxes and gross receipts taxes on telecommunications.
19. Corporate income (franchise) tax, tax on dealers of intangibles, and pass-through entities.
20. Estimates of compliance effect included in static effect estimates.

Appendix TABLE 1C						
Estimated Revenue Impact of H.R. 1956 by State: Maximum Impact						
Fiscal Year 2007						
Dollar Amounts in Millions						
	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
21. State only. Corporate income and excise taxes only.						
22.Bank Tax only						
23. Includes Excise & Franchise Tax, Local Business Tax, and Professional Privilege Tax.						
24. Corporate Franchise Tax only.						
25. Reported only minor revenue impact because physical presence is nexus standard.						
26. State and local Business & Occupation Tax and State and local Public Utility Taxes.						

LETTER TO THE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW FROM PAUL J. GESSING, DIRECTOR OF GOVERNMENT AFFAIRS, NATIONAL TAXPAYERS UNION (NTU)

September 27, 2005

A Statement to the Members of the Commercial and Administrative Law Subcommittee on H.R. 1956, the Business Activity Tax Simplification Act

Dear Subcommittee Members:

On behalf of the 350,000-member National Taxpayers Union (NTU), I am pleased to offer comments regarding legislation that, if passed, would be an important step toward fulfilling our core mission, namely the simplification and clarification of our tax system. The Business Activity Tax Simplification Act is a worthy reform measure that would clarify the nexus rules that govern state assessment of income-based taxes and establish a clear physical presence nexus test to ensure that only businesses having employees or property physically present within a jurisdiction are subjected to business activity taxes in that jurisdiction.

In 1992, the U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that a state could not impose taxes on an out-of-state business unless that business has a "substantial nexus" within the taxing state. However, the Supreme Court declined to rule on the nexus standard as applied to business activity taxes, and decided to allow Congress to resolve the dispute. To date, it has not done so.

The integration of the Internet and telecommunications technologies has allowed businesses of all sizes to expand across state lines, and interstate business activities are now commonplace. However, these beneficial developments have also highlighted existing confusion over when states are allowed to collect income taxes from out-of-state companies conducting certain activities within their jurisdiction. Unfortunately, jurisdictions are increasingly defining "substantial nexus" differently, leading to a complex matrix of tax rules. If this practice continues, it will have a dire effect on interstate commerce and the entire economy.

In order to illustrate some of the significant problems with lack of clarity in state enforcement of business activity taxes, I would like to offer just a few examples of how arbitrary these policies can become. In Tennessee, the revenue department attempted to tax an out-of-state company engaging in credit card solicitation activities through direct mailings. The department based their authority on the presence of the credit cards and the "substantial privilege of carrying on business" in Tennessee.

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A further illustration of the basic confusion over nexus is that some states assert that a business whose trucks pass through their confines six or fewer times in a year – without picking up or delivering goods – has sufficient connections with the state to trigger business activity taxes. Other states contend that having a website on a server in the state creates a sufficient connection to justify imposing these taxes. Some states even take the position that registering to do business in a state, or listing a phone number in a local phone book in that state, is a sufficient connection to justify taxation. Although it is NTU's belief that these are examples of overzealous tax collection on the part of certain states, there is no question that uniformity is necessary and that the Congress is the correct body to provide such clarity.

H.R. 1956 would end these harmful practices by establishing specific standards that define when firms should be obliged to pay business activity taxes. The legislation ensures fairness, minimizes litigation, and creates a legally certain business climate that encourages companies to invest and expand interstate commerce. This legislation is a common-sense way for Congress to promote economic growth and we urge Members of the Subcommittee to support it.

Sincerely,

Paul Gessing

Paul J. Gessing
Director of Government Affairs

LETTER TO THE HONORABLE MELVIN L. WATT FROM THE HONORABLE MARC BASNIGHT, A SENATOR OF THE NORTH CAROLINA GENERAL ASSEMBLY, SUBMITTED BY THE HONORABLE WILLIAM D. DELAHUNT

NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE BUILDING

RALEIGH 27601

September 23, 2005

The Honorable Mel Watt
United States House of Representatives
2236 Rayburn House Office Building
Washington, DC 20515-3312

Dear Congressman Watt:

I have been made aware that proposed legislation titled "Business Activity Tax Simplification Act of 2005", H.R. 1956, will be the subject of a hearing before the Subcommittee on Commercial and Administrative Law on Tuesday, September 27. After a preliminary review of the provisions of the bill and the fiscal impact analysis conducted by the Department of Revenue, as well as the numbers reported by states across the nation, I feel compelled to relay my concern regarding the implications of the bill.

Each year the Legislature is challenged to craft a budget that provides all the benefits the citizens and businesses of North Carolina deserve. In recent years that challenge has seemed almost insurmountable. It is our responsibility as legislators to ensure that our children are provided a good education system, that our citizens have available to them quality jobs, and that the State's employees have competitive salaries and benefits. Additionally, we must maintain reserves to assist in times of natural disasters such as those experienced recently. Now we face the prospect of a different kind of disaster: the annual loss of approximately $337 million in tax revenue if this legislation is enacted. There are only two options to overcome a loss of this magnitude. They are the increase of taxes or elimination of essential services. Neither is an acceptable option.

This Legislature has worked diligently to attract industry to this State that will provide quality jobs for our citizens. The provisions of H.R. 1956 create a disincentive for industry to expand beyond its home state. The bill is said to create a physical presence standard, yet multiple provisions permit a company to escape taxation even with significant personnel and property in the State. Therefore, a business is less likely to move a significant amount of its operation into this State if it can exploit the market without becoming subject to tax. Furthermore, the out-of-state business then gains an advantage over North Carolina businesses offering the same products.

Lastly, we oppose H.R. 1956 because it violates the state's sovereign right to determine its own tax policy. The provisions of this proposed legislation would make void legislation this body enacted to curb the practice by some corporations of shifting income earned in this State to non-taxing jurisdictions. Therefore, I strongly urge you to oppose any physical presence nexus standard.

Sincerely,

Marc Basnight

LETTER TO THE HONORABLE MELVIN L. WATT FROM THE HONORABLE JAMES B. BLACK, A REPRESENTATIVE OF THE NORTH CAROLINA GENERAL ASSEMBLY, AND SPEAKER OF THE NORTH CAROLINIA HOUSE OF REPRESENTATIVES, SUBMITTED BY THE HONORABLE WILLIAM D. DELAHUNT

Office of the Speaker
North Carolina House of Representatives
Raleigh 27601-1096

JAMES B. BLACK
SPEAKER

September 22, 2005

LEGISLATIVE BUILDING
PHONE: (919) 733-3451

The Honorable Mel Watt
U.S. House of Representatives
2236 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Watt:

I am writing to you to express my opposition to legislation that will be heard before your House Judiciary subcommittee next week. It is my understanding that the provisions of H.R. 1956, "Business Activity Tax Simplification Act of 2005", will cost the State millions of dollars in the first year, and this cost will increase as corporations develop more tax sheltering methods.

The title of the bill indicates that it "simplifies" business activity tax. As I have been told, it is anything but simple. It proposes a bright line physical presence standard for nexus, yet there are multiple exceptions to the rule that are complex and will surely keep litigators busy for years to come.

The great percentage of businesses in this State fall in the category of "small to mid-sized business". It is my understanding that H.R. 1956 is crafted to give an advantage to large multistate companies that can afford to structure their businesses to compete with our in-state companies but not share the tax burden. I'm sure you understand the monumental task the General Assembly faces each year in crafting a budget that meets the needs of our citizens while minimizing the tax burden. That burden should be spread fairly among all companies that earn income within the borders of this State. Please oppose H.R. 1956, which will create an uneven playing field for companies in this State.

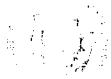
Thank you for your time.

Sincerely,

James B. Black

James B. Black
Speaker

LETTER TO THE HONORABLE MELVIN L. WATT FROM THE HONORABLE MICHAEL F. EASLEY, GOVERNOR, STATE OF NORTH CAROLINA, SUBMITTED BY THE HONORABLE WILLIAM D. DELAHUNT



STATE OF NORTH CAROLINA
OFFICE OF THE GOVERNOR
20301 MAIL SERVICE CENTER • RALEIGH, NC 27699-0301

MICHAEL F. EASLEY
GOVERNOR

September 21, 2005

The Honorable Mel Watt
United States House of Representatives
B-351C Rayburn Building
Washington, DC 20515

Dear Congressman Watt:

I have corresponded with you on several occasions over the course of the last three years expressing my opposition to proposed federal legislation that limits the state's right to impose an income tax on non-North Carolina businesses that realize income from the North Carolina market. The current version of the bill is H.R. 1956, "Business Activity Tax Simplification Act of 2005" and its provisions are essentially the same as previous BAT bills. I am writing again to urge you to oppose H.R. 1956.

The State of North Carolina's opposition is based on several factors:

- **The legislation hurts our ability to attract jobs and investment to North Carolina by providing incentives to businesses to set up corporations in other states that do not tax royalty or intangible asset income.** North Carolina courts have ruled that the use of an intangible asset in North Carolina constitutes nexus and the income from the asset should be taxed here. This federal legislation would overturn that ruling and frustrate our attempts to receive a fair share of taxes from corporations conducting substantial business activity here.

  Revenue Secretary Norris Tolson and his staff can provide you with examples of how this legislation could be abused.

- **The legislation would cost the state millions of dollars in corporate tax income.** As you know, North Carolina has invested more in education, healthcare, and public safety in order to remain competitive and provide for the least of our citizens. The State should be able to rely on corporations that benefit from the market in North Carolina to help shoulder the responsibility of providing services and aid to the citizens that make up the market.

LOCATION: 116 WEST JONES STREET • RALEIGH, NC • TELEPHONE: (919) 733-5811

The Honorable Mel Watt
Page 2
September 21, 2005

Our state and local tax burden on business is one of the lowest in America. We provide tax incentives to reduce the tax burden on companies that provide new jobs and investment in our state, as those incentives serve a public purpose. But I am asking you to support the State and its citizens by opposing H.R. 1956 with its provisions to legalize income-shifting schemes and its many safe harbors to permit corporations to exploit the North Carolina market with no tax liability and no public purpose.

With kindest regards, I remain

Very truly yours,

Mike Easley

Michael F. Easley

MFE/DG:ab

cc: [redacted]

LETTER TO THE HONORABLE MELVIN L. WATT FROM THE E. NORRIS TOLSON, SECRETARY, NORTH CAROLINA DEPARTMENT OF REVENUE, SUBMITTED BY THE HONORABLE WILLIAM D. DELAHUNT

North Carolina Department of Revenue

Michael F. Easley
Governor

September 21, 2005

E. Norris Tolson
Secretary

The Honorable Mel Watt
United States House of Representatives
2236 Rayburn House
Office Building
Washington, D.C. 20515

Dear Representative Watt:

I have been advised that the latest version of the "Business Activity Tax Simplification Act of 2005", H.R. 1956, is scheduled for hearing before the Judiciary Committee next Tuesday. I appreciate your willingness to hear us on this matter and again express my deep concerns about the ramifications of this legislation. As I've mentioned before, the possible economic impact of the BAT bill on North Carolina has been estimated to be $337 million. Based on our experience with our recent Voluntary Compliance Program (VCP), we may have seriously under-estimated the fiscal impact.

Earlier this year, we instituted the VCP, giving any corporation the opportunity to come forward and identify tax shelter schemes it had utilized to avoid North Carolina corporate income and franchise taxes. Under the terms of the VCP, taxpayers were required to pay 100% of the underpaid North Carolina tax and interest and give up their right to seek a refund of the tax paid. In return, the Department of Revenue agreed to waive all penalties and not pursue criminal action. More than 325 corporations came forward to participate in the program and have paid nearly $300 million. We are aware that not all companies that participated in such schemes came forward and instead chose to play the "audit lottery". H.R. 1956 will legalize the very activities acknowledged by these corporations as ones that shifted income away from the jurisdiction in which the income was earned.

I find it disturbing that the proponents of the BAT bill tout it as nexus simplification by establishing a physical presence standard and then include a laundry list of safe harbors: activities that clearly constitute physical presence but are exempt activities. The exceptions are poorly defined and will lead to years of litigation.

Additionally, some of the same corporations that are members of the coalitions urging Congress to pass H.R. 1956 are lobbying at the state level to minimize tax liability by establishing a sales factor only apportionment, arguing that such a change promotes economic development. This approach reduces the factor of in-state companies because

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no weight is given to capital investment in the state. The result is to shift the corporate tax burden from those with significant bricks and mortar in a state to those that have only a small presence there. During the North Carolina legislative session that just ended, a bill was introduced to exempt all income from manufacturing activity in this State from taxation. If lobbyists are successful on both fronts, the corporate income tax will virtually be eliminated. The 2006-2007 state budget is based on anticipated corporate tax receipts of $950 million. With this significant erosion of the tax base, how are we to educate our children, provide essential services and basic protection to our citizens, or rebuild after a disaster?

Lastly, I continue to oppose H.R. 1956 because it constitutes an unfunded federal mandate. Under the concepts of federalism, it is the state's sovereign right to determine its own tax policy. The provisions of this proposed legislation would make void legislation that our General Assembly enacted to curb the practice by some corporations of shifting income earned in this State to non-taxing jurisdictions. Many of the activities being used by corporations to shift income are substantially the same as those activities used to shift federal taxable income offshore. It is ironic that Congress would consider legislation to permit at the state level activity that it is trying to shut down at the federal level. Therefore, we strongly urge you to oppose any physical presence nexus standard.

During our meeting in your office in April, you asked us if there was any alternative to the currently proposed BAT legislation. Again, I do not believe that any action by Congress in this area is necessary. However, if Congress is intent on addressing BAT legislation, serious consideration should be given to a model statute crafted in 2002 by member states of the Multistate Tax Commission, including North Carolina. Under that concept, nexus is determined based on the amount of a corporation's property, payroll, or sales present in a state. If any of the factors exceeds a pre-determined threshold, the corporation establishes nexus in that state. Of course, taking this route would require the repeal of P.L. 86-272 which prohibits a state from asserting a tax liability if a corporation's only activity in the state is solicitation of sales of tangible personal property. A copy of the model statute is enclosed for your convenience.

Thank you for your interest in this issue and for hearing our concerns. I will be out of the country next week and unable to attend the hearing. I will have a member of my staff present as an indication of our interest in this bill. Please call me if you have any questions about our position.

Sincerely,

E. Norris Tolson, Secretary
North Carolina Department of Revenue

ENT/LC/at

Enclosure

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.

LETTER TO THE HONORABLE CHRIS CANNON FROM RICHARD J.M. POULSON, EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL & SENIOR ADVISOR TO CHAIRMAN, AND VERNON T. TURNER, CORPORATE TAX DIRECTOR, SMITHFIELD FOODS, INC. (SMITHFIELD)

Smithfield

Smithfield Foods Inc.
200 Commerce Street
Smithfield, VA 23430

(757) 365-3000 tel
(757) 365-1835 fax

September 26, 2005

The Honorable Chris Cannon
U.S. House of Representatives
Chairman, Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
B-353 Rayburn House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act (H.R. 1956)

Dear Chairman Cannon:

I would like to thank you for the opportunity to submit this letter for the record on behalf of Smithfield Foods, Inc. ("Smithfield") for the September 27, 2005 legislative hearing on H.R. 1956, the Business Activity Tax Simplification Act of 2005 ("BATSA"). Smithfield is the world's largest pork processor and hog producer, with sales in all fifty states and globally in excess of $11 billion.

Current U.S. Federal legislation on state income taxation where no physical presence exists is found in Public Law 86-272. This Federal law provides that states cannot impose a net income tax on the interstate solicitations of tangible personal property. The U.S. Supreme Court further provided a brightline physical presence test for state use tax collection (*Quill Corporation v. North Dakota)*. The states and other tax experts have ranged widely in their interpretation on the breadth or limits, as the case may be, on when state income taxes can be imposed in the years since the enactment of Public Law 86-272 and the Quill decision. The gap in the law has a chilling effect on interstate commerce because of the uncertainty, confusion and inconsistencies in application of the current state tax law found across the U.S.

The consequences of uncertain state tax laws are evidenced in the high costs for companies to comply with numerous state tax laws and possibly protracted litigation, delays in product shipments due to seizures of goods, assessment of penalties in cases where interpretations differ, the loss of productivity with the numerous and complicated filings, and even unfairness against small businesses that seek to expand their sales across state lines. Small businesses do not necessarily have the resources of large corporations to deal easily with protracted litigation or navigating the myriad state tax requirements. BATSA seeks to fill the gap in legislation and remove bureaucratic arbitrariness and inconsistencies in application, making more transparent state tax requirements across the U.S. It seeks to do no more than what U.S. Federal tax law requires in international tax situations, with the "permanent establishment" theory.

Smithfield had the privilege of testifying at least year's hearing on H.R. 3220, the Business Activity Tax Simplification Act of 2003. We were asked to testify because our company knows firsthand the difficulties of doing business on a day-to-day basis across state lines due to the many interpretations of current interstate tax law (i.e.: *Public Law 86-272 and Quill*). During the hearing we recounted an illustrative incident that occurred in September 2002, when the New Jersey

Department of Taxation stopped one of our trucks and demanded money in return for the release of the truck and its driver. The demand was made despite the fact that Smithfield has no physical presence in the state and that, in the end, the New Jersey Department of Taxation agreed that Smithfield owed no such taxes.

A full account of the incident and our responses to questions is available on pages 36-38, and 61-64 of the *Hearing before the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary House of Representatives One Hundred Eighth Congress Second Session on H.R. 3220*, May 13, 2004, available at the following web address:
<http://judiciary.house.gov/media/pdfs/printers/108th/93657.PDF>.

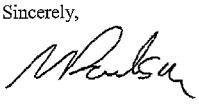
Unfortunately, our story did not end there. Rather than being just an isolated incident, it happened again, not long after our May 2004 testimony. In December of 2004, a truck belonging to one of our subsidiaries was seized at a Costco distribution facility in New Jersey. To resolve the situation, we spoke with a person who was part of a special tax force within the New Jersey Department of Revenue (the "Special Tax Agent").

The Special Tax Agent had detained the truck for the alleged non-payment of New Jersey taxes. This person demanded $80,000 to release the truck. After hours of difficult discussion, $13,400 was mutually agreed to as a jeopardy assessment in order to release the truck. Smithfield filed a refund claim with New Jersey and ultimately received most of the $13,400, less processing costs and some fees. Smithfield was again exonerated but there is no assurance that it will not happen once, twice, or multiple times, with perhaps with even more disruptive consequences. These events demonstrate the surprise and unfairness in the state tax assessment process.

BATSA seeks to establish a clear physical presence standard that is easy to follow, comply with, and enforce. BATSA will resolve inconsistencies in the interpretation and application of current state tax laws on interstate sales of tangible personal property when no physical presence exists. Passage of BATSA will serve to reduce bureaucratic arbitrariness in the imposition of business net income taxes, and reduce the inherent unfairness toward small businesses that are discouraged from expansion by onerous, complicated and burdensome interstate tax laws. This promotes the expenditure of limited resources on what businesses are meant to do—make sales and build revenues.

Smithfield strongly supports passage of BATSA and stands ready to provide support and information to help ensure that a more transparent and consistent physical presence standard becomes part of the law on business activity taxes. Thank you for your time and attention to our concerns.

Sincerely,



Richard J.M. Poulson
Executive Vice President, General Counsel & Senior Advisor to Chairman

Vernon T. Turner
Corporate Tax Director

PREPARED STATEMENT OF THE SOFTWARE FINANCE AND TAX EXECUTIVES COUNCIL

The Software Finance and Tax Executives Council (SoFTEC) is an organization comprised of major software companies and its mission is to provide software industry focused public policy advocacy on tax and finance issues. Taxation of interstate commerce is an issue in which software companies have long held a keen interest because their customers deploy their products in every state and most every locality.

SoFTEC advocates policies that promote fairness, efficiency and certainty in the interstate taxation of software transactions. Because H.R. 1956, the subject of this hearing, goes to the heart of these policies, SoFTEC has been following it very closely.

1. OVERVIEW OF THE SOFTWARE INDUSTRY AND SOFTWARE DISTRIBUTION:

The software industry is a human capital-intensive industry. Software companies rely on the personnel in their research and development departments to design and test new products and new versions of existing products to remain competitive. Once the research and development team has completed a new product or a new version of an existing product, the marginal cost of making each successive copy approaches zero. There is no need to build a factory to manufacture software products.

Computer software is a product that can be distributed using a variety of techniques. Software is available in retail stores where customers can purchase a prepackaged copy. Copies of computer software can be delivered electronically using the Internet or other network. Software companies can distribute their products to large customers by delivering a single copy of a computer program along with a license to make a given number of copies or a license to a make any number of copies necessary to meet the customer's needs. Additionally, a customer might receive a single copy along with a license allowing it to be loaded on to a computer server that can be accessed by the customer's employees from multiple locations. Last, it is not necessary to deliver to the customer a copy of the computer program at all; the software company might load its product onto its own server and allow customers to access the software's functionality remotely. Software distribution techniques are constantly changing as technology advances.

Some software companies enter into partnerships with other companies that specialize in the delivery of comprehensive business solutions with software as one component. For instance, one of these third-party vendors might license different software from several companies, combine the various software with computer hardware and market the package. The third-party will remit a royalty to the software company based on each sale. The software company may not know who the third-party's customers are or where they are located.

For a variety of legal and business reasons, software companies generally do not "sell" copies of their products to their customers. Instead, they distribute copies of their products subject to a license agreement. Under the terms of these end user license agreements, the customers receive the contractual right to use the software while the software company retains legal title to the copy. The license agreement may also provide the customer with the right to make copies of the computer program for use within the customer's business. The license agreement generally prohibits the transfer by the customer of any of the copies outside of the business and are prohibited from "reverse engineering" or "decompiling" the software which could expose trade secrets.

As can be seen, with regard to a number of these software distribution techniques, the software company loses control over where the customer might use copies of its products. If the customer receives a license to make a certain number of copies or any number of copies for use anywhere in its business, the customer takes control over where best to use the copies. Nevertheless, the software company will retain an ownership interest in every one of those copies no matter where the customer chooses to use them. Likewise, if the software company puts its products on its own server and allows the customer's employees remote access to the software's functionality, the software company cares not a fig where the customer or its employees might be located when accessing the software. The same is true when the customer loads the software on its own server and allows its employees access to the software from multiple locations; the software companies does not know where those employees are located when they access the software, nor should they care.

2. CONSTITUTIONAL NEXUS STANDARDS FOR BUSINESS ACTIVITY TAXES:

The law is clear that a state cannot impose a tax on an out-of-state business unless that business has a "substantial nexus" with the taxing state.[1] The Supreme Court, on at least two occasions, in the context of sales and use taxes, has construed this "substantial nexus" requirement as requiring that the out-of-state business have "more than de minimis" physical presence in the taxing state.[2]

An older line of Supreme Court precedents holds that taxpayers acquire a substantial nexus with another state through continuous and systematic contacts with the state.[3] The Supreme Court later added the requirement that the contacts must be related to the establishment and maintenance in the state of a market for the putative taxpayer's products.[4] However, in all of these cases, the taxpayers had an actual physical presence in the taxing state. In addition, all of these cases were decided prior to the *Quill* case, which separated the Commerce Clause analysis from the Due Process clause analysis and held that a physical presence was required in order to require out-of-state businesses to collect sales and use taxes under the Commerce Clause.

Many state revenue department claim that under current law, any company "doing business within a state" must pay business activity taxes on income earned in the taxing state, even if the company has no physical presence in the state. As authority for this theory, they often cite two older Supreme Court cases—*Shaffer v. Carter,* 252 U.S. 37 (1920) and *New York Ex Rel. Whitney v. Graves et al.,* 299 U.S. 366 (1937). Even a cursory reading of these cases reveals that neither stands for any such proposition.

Shaffer v. Carter involved the attempt by Oklahoma to tax income from oil and gas wells located in Oklahoma and owned by a Chicago resident. The Supreme Court held that the Due Process clause does not bar a state from imposing an annual tax on net income derived by nonresidents from property owned by them within the state. The Court's holding centered squarely on Oklahoma's jurisdiction over property within its borders and the fact that the income it was attempting to tax derived from such property. Those states seem to be taking language in the opinion about a state's right to tax nonresidents "doing business in the state" out of context to support their claims that physical presence is not required for business activity tax nexus purposes. However, this case did not involve a naked claim by Oklahoma of the right to impose business activity taxes on companies "doing business in the state" with no physical presence. All of the income at issue in the case arose from the sale of oil and gas extracted from the ground in Oklahoma.

State revenue departments likewise misconstrue the holding in *New York Ex Rel. Whitney v. Graves.* Here, Mr. Whitney, a Massachusetts resident, and his partners owned a seat on the New York Stock Exchange. In 1929, the exchange granted each of its members a "right" to one-fourth of a new membership. Mr. Whitney sold this right and New York assessed a tax on the profits from the sale. The Supreme Court upheld the tax and, in doing so, applied an exception to the general common law rule that the situs of intangible property is, for tax purposes, the owner's domicile. The Court's decision was based on the unique characteristics of seats on a stock exchange, and its holding stands for the proposition that the situs of seats on a stock exchange, for tax purposes, is the state in which the exchange is located. Nothing more can be inferred from this decision.

On the other hand, numerous recent state level cases have construed the *Quill* physical presence requirement to be applicable to business activity taxes.[5] Only South Carolina has taken the position to date that the presence of intangible property in the state alone is sufficient to establish nexus.[6] While the Supreme Court

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[1] See e.g., *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977) (A state tax on out-of-state businesses has been sustained against a Commerce Clause challenge "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State.").

[2] See *National Bellas Hess, Inc. v. Department of Revenue. of Ill.,* 386 U.S. 753 (1967), *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

[3] See *International Shoe Co. v. Washington,* 326 U.S. 310 (1945); *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450 (1959); *Scripto Inc. v. Carson,* 362 U.S. 207 (1960).

[4] See *Tyler Pipe Industries Inc. v. Washington State Dep't of Rev.,* 483 U.S. 232, 250 (1987).

[5] See *J.C. Penny Nat'l Bank v. Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal den.* (Tenn. 2000), *cert. den.* 531 U.S. 927, 212 S.Ct. 305 (2000); *Rylander v. Bandag Licensing Corporation,* 18 S.W.3d 296 (Tex. App. 2000), Motion for Rehearing Denied March 8, 2001; 9.4 *Percent Manufactured Housing Service v. Department of Revenue,* No. Corp. Inc. 95–162 (Ala. Admin. Law Div. Feb.7, 1996); *MeritCare Hospital v. Commissioner of Revenue,* No. C2–94–12818, (D.C. Minn. Sept. 22, 1995).

[6] *Geoffrey, Inc. v. South Carolina Tax Commission,* 313 S.C. 15 (1993).

has not yet ruled on whether the *Quill* "physical presence" test extends to business activity taxes, there are no cases in which the Court has upheld a state business activity tax where the out-of-state company had absolutely no physical presence in the taxing state. Even more importantly, there is no rational justification for the proposition that the Supreme Court's "substantial nexus" requirement should equate with physical presence for sales and use tax collection purposes, but that a lower standard (i.e., "economic nexus") should apply for business activity taxes.

Thus, a fair reading of the current state of the law, as interpreted by the state courts rather than state tax administrators, is that in order for a state to assert a claim for business activity taxes against an out-of-state business, that business must have some physical presence in the taxing state. Some states such as South Carolina and Oregon reject the existing physical presence requirement with regard to business activity tax nexus and are seeking to expand their right to tax out-of-state businesses that have only an economic presence in the state. This is exactly why there is a critical need for the enactment of bright line standards for business activity tax nexus.

3. IMPACT OF AN "ECONOMIC NEXUS" STANDARD ON SOFTWARE DISTRIBUTION:

As indicated above, many state revenue departments construe their "doing business" tax statutes as requiring nothing more than the existence of a customer in their state in order to impose a business activity tax on an out-of-state business otherwise having no employees or property within their state. As indicated above, we believe that those states exceed their constitutional authority to project their taxing power outside their borders. As shown below, such a low nexus standard would wreck havoc on common software distribution techniques and make any attempt at tax compliance overly burdensome.

Many businesses deploy software throughout their business. Large businesses present in many states and localities generally take delivery of computer software at a single location and they make copies and deploy them where needed. Alternatively, the software company could deliver multiple copies of its products leaving the customer free to send such copies wherever the need arises. The software company many times will have no knowledge where the customer has deployed the software.

An economic nexus standard would give state and local revenue departments the ability to claim that a software company owes business activity taxes wherever the customer has an employee using the software. Such a standard, were it to become widespread, would require that software vendors build into their license agreements elaborate provisions requiring that the customer closely track the deployment of the software throughout its business and submit reports to the software company. The software company would then have to use those reports to figure out where it owed tax. On audit, the software company would bear the risk of the accuracy of its customers' reports. An economic nexus standard would cause a software company to be doing business in nearly every jurisdiction where its customers are doing business.

An economic nexus standard also would give states a reason to claim that the retention of ownership by software companies to the copies of computer programs constitutes the ownership of property sufficient to rest a claim of liability for business activity tax. Yet, as explained above, the software company typically has no information as to where the customer may be using the copy of the software. Making the software company liable for business activity tax in every jurisdiction where its customers may be using its software would impose an unreasonable burden on interstate commerce.

4. EFFECT OF H.R. 1956 ON SOFTWARE COMPANIES:

Section 2 of H.R. 1956 would expand the scope of Public Law 86–272. Currently, P.L. 86–272 provides that states cannot impose an income tax against an out of state company whose only activities in the taxing state consists of sending employees into the state who solicit order for sales of tangible personal property where the orders are sent out of state for acceptance and the goods are shipped into the state by common carrier. The business model contemplated by P.L 86–272 is the door-to-door salesperson common in the late 1950's when the statute was enacted.

P.L 86–272 only applies to companies that engage in "sales" of "tangible personal property." Many states claim that P.L. 86–272 does not apply to software transactions either because software is not tangible personal property or because software is licensed and not sold. Other states skirt P.L. 86–272 by enacting taxes other than income taxes.

H.R. 1956 would modernize P.L. 86–272 by eliminating its limitation to sales transactions; it would apply to all "transactions," including license transactions. It

would eliminate the limitation to tangible personal property by expanding it to include all forms of property and services. Last, it would broaden P.L. 86–272 so that it applied to all types of business activity taxes, not just income taxes. This would close a major loophole that has limited the effectiveness of P.L. 86–272 in recent years. The amendments to P.L. 86–272 would make it more effective for software companies because they have large sales forces that regularly solicit orders, send them out of state for acceptance and fill them by shipment from out of state.

Section 3(a) of H.R. 1956 would codify into federal law the judicially mandated "physical presence" standard and would put an end to the "economic nexus" standard claimed by many state revenue departments. This provision is the keystone of the legislation. This provision would eliminate claims against software companies for business activity taxes based on access by employees of a customer to software functionality. As explained above, some software companies deliver a copy of a computer program to a customer, the customer loads the copy onto a server, and employees of the customer, wherever they might be located, can remotely access the software functionality. In addition, some software companies put their software onto their own servers and allow their customers' employees remote access to the software. Under a physical presence standard, neither of these software business models would give rise to a taxable presence in the jurisdiction from where the software functionally is remotely accessed.

We are concerned however about the provisions of Section 3(b) which puts meat on the bones of the term "physical presence." Under Section 3(b)(3), a business would have a physical presence in every state in which it owned tangible personal property for more than 21 days. Our concern is with respect to garden-variety software transactions where the software company retains title both to the copies of the software that are transferred to the customer and the copies which the customer might make under license for internal use. We believe that Section 3(b)(3) of the Bill would give software companies a taxable presence in all jurisdictions where a copy of its software might be located.

We believe that the Bill should be amended to make clear that retention of ownership of copies of computer software delivered to end users is not ownership of property for purposes of Section 3(b)(3) of the Bill.

5. CONCLUSION:

With the one exception noted immediately above, we believe that H.R. 1956, the Business Activity Tax Simplification Act of 2005 would go a long way towards eliminating uncertainty in with regard to where companies engaged in interstate commerce are liable for business activity taxes. We look forward to working with the committee as the Bill moves through the Congress.

PREPARED STATEMENT OF CHRIS ATKINS, STAFF ATTORNEY, THE TAX FOUNDATION

September 21, 2005

Paying for "Civilized Society" in the Global Marketplace:

H.R. 1956's General Physical Presence Rule for State Business Activity Taxes Accurately Matches Taxes Paid and Benefits Received

by Chris Atkins
Staff Attorney

Introduction

Imagine you are the proprietor of a small software company, selling your products to customers all over the United States. Your offices are based in your home in South Carolina. You are the only employee of the company. You make occasional sales trips to other states, but generally only sell through advertising your products in magazines and on your website.

You recently made a sale to a customer in New Jersey. The customer is a casino and is using your software to help manage its activities. One day, you receive a letter from the state of New Jersey. They demand taxes from you for the privilege of doing business in New Jersey, and they want you to register to do business in the state. The total cost of the registration fee plus the minimum taxes due exceeds the revenue received from the software sold to your New Jersey customer.[1]

Is it right for New Jersey to levy taxes on your small software company? Oliver Wendell Holmes once said that taxes are what we pay for civilized society. But is it right for a small business with no offices, employees, or other physical presence in New Jersey to pay taxes for government services offered in the Garden State?

H.R. 1956, the Business Activity Tax Simplification Act of 2005, would require a corporation to have employees or real property physically present in a state before it could be required to pay state business activity taxes (e.g., income, franchise, or gross receipts taxes). Physical presence—as opposed to the most popular alternative, economic presence—is the correct standard for our 21st century international economy. Under physical presence, your small software company would not have to pay tax in New Jersey or anywhere else in the world where you merely sell products to customers.

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[1] This factual situation is based on actual events. *See Business Activity Tax Simplification Act of 2003: Hearings before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee*, 108th Cong., 2d Sess (2004) (letter of Bo Horne).

Physical vs. Economic Presence
The physical presence rule would require a business to pay state business activity taxes only where it has offices, factories, warehouses, inventory, employees, or other property (see Table 1). H.R. 1956 defines physical presence as being individually present in a state, leasing or owning property, or using the services of another to establish and maintain a market for sales.[2] In the previous example, the small South Carolina software company was never physically present in New Jersey and thus would not be required to pay New Jersey tax under the physical presence standard.

Table 1: More Activities Generate Economic Presence than Physical Presence

Physical Presence	***Economic Presence***
Headquarters	Headquarters
Offices	Offices
Employees	Employees
Leasing or owning tangible property	Leasing or owning tangible property
Independent contractors	Independent contractors
	Sales
	Deriving income
	Advertising

In contrast, economic presence would require a business to pay tax not only to those states where it has physical presence, but also to those states where it makes sales or derives income from customers (see Table 1). In the previous example, the small South Carolina software company had economic presence in New Jersey since it derived income from the sale of software to the New Jersey casino.

Physical Presence More Accurately Tracks Benefits
If, as Justice Holmes said, "Taxes are what we pay for civilized society," then it seems reasonable that those receiving the benefits of civilization pay the costs of maintaining it. In the context of state taxes on corporations (e.g., income, gross receipts, franchise), the physical presence standard more accurately tracks the benefits received by corporations from state governments for which they can be expected to pay taxes.

Supporters of economic presence claim that corporations are benefiting from education, transportation, and a viable economic market in those places in which they have customers, and thus should be expected to pay taxes in those states as well.[3] Supporters of physical presence, however, maintain that the physical presence rule gauges benefits better because it ties taxes paid to the states and communities in which the corporation is

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[2] Business Activity Tax Simplification Act of 2005, H.R. 1956, 109th Cong. § 3(b)(1)-(3) (2005). H.R. 1956 does create some exemptions from the general physical presence requirement, such as the gathering of news activities.

[3] *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 (9/15/2004) (states have a right to "tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.").

actually employing labor and capital and thus actually benefiting from public services such as education, transportation, and public safety (i.e., police and fire fighters).[4]

Who is correct? It is important to understand, at the outset, that merely giving a benefit (however small or remote) to a corporation is not sufficient to impose taxes. If that were the case, states would be able to tax many firms with trivial or practically non-existent business dealings in their state.

For instance, if New Jersey can extract taxes from the South Carolina software company merely because the state provides a marketplace for goods and services, then surely each state through which those goods and services travel can also claim they are providing the benefits of highways and roads. A truck carrying its product from South Carolina to New Jersey passes through at least four states if it travels directly (see Table 2). If a package is shipped via FedEx it may be routed through Memphis, where Tennessee might claim the right to tax because it provided an orderly marketplace for the FedEx hub. Also, if a sales contract contains a choice of law clause detailing, for example, that the law of Delaware controls any dispute on the contract, Delaware might claim a right to tax for providing its legal structures.

Table 2: Possible States that Could Demand Tax from a South Carolina Software Firm that Makes a Sale in New Jersey

State	***Benefit Given***
South Carolina	State and local services
New Jersey	Orderly marketplace for goods and services
North Carolina	Roads (if shipped directly)
Virginia	Roads (if shipped directly)
Maryland	Roads (if shipped directly)
Pennsylvania	Roads (if shipped directly)
Delaware	Choice of law clause in sales contract
Tennessee	Transportation hub (If shipped by FedEx)
New York	Accounting services for sales
Washington	Software used to develop the product

Furthermore, the South Carolina software company in the previous example also benefits from the inputs of production and the government services in those states in which those inputs were produced. If it bought software from Washington State to help develop its own software products, and purchased accounting services from New York, those states might demand taxes in exchange for the orderly market in which its business inputs were produced and shipped or delivered to it.

[4] *See* 108th Cong., 2d Sess 12 (2004), supra note 1, (statement of Arthur Rosen) ("…states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, 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.").

It is also unclear why producers should be liable to pay tax in the customer's state while customers are free from paying tax in the producer's state. If the producer is receiving benefits from the customer's state, then the customer is also receiving benefits from the producer's state. Why should the corporation who produces and ships the product be the only one required to pay taxes to support the market in the destination state?[5] For that matter, the customer could also be expected, under a real economic presence standard, to remit tax to every state from which he, like the producer, receives a benefit (see Table 2).

It is easy to see how quickly the number of states in which we have to pay tax multiplies if we are expected to pay tax for any benefit—no matter how small—received from any state. Thus, it becomes necessary for the law to make qualitative judgments about which states have given benefits sufficient to expect a payment of tax in return. In making those qualitative judgments, it is clear that the economic presence rule would subject corporations to taxation that is too widespread and expansive to support an integrated, national economy.

The physical presence rule matches benefits received with taxes paid without wading into the complicated questions above. The producer pays for the benefits in the state where the product is shipped from, and the customer pays for the benefits received in the state to which the product is shipped. Physical presence provides a legal rule that is equitable, easy to enforce, and simple for companies to comply with. Economic presence, on the other hand, rewards states (via taxes from out of state companies) for merely doing what they ought to do in our free-market, open-economy federalist society, i.e., providing an organized marketplace for their goods and services.

Physical Presence Works Better in a Global Marketplace

The United States generally adheres to the Model Tax Convention of the Organisation for Economic Cooperation and Development (OECD). The OECD's model tax language forms the basis for many tax treaties that the United States maintains with foreign countries, such as Australia.[6] Part of this model language is the permanent establishment rule, which says that neither the U.S. nor its treaty partner will seek to tax the income of a multinational corporation unless it has a "fixed place of business through which the business of an enterprise is wholly or partly carried on."

Making sales or deriving income in a country is not sufficient, in the international context, to require the payment of taxes. The OECD's model language thus thoroughly rejects the idea of economic presence, and the U.S. has committed itself to not taxing the income of many foreign-based corporations unless they have a physical presence in the United States, no matter how much they advertise and sell here.

Table 3 shows how state economic presence standards disadvantage U.S.-based corporations selling in the United States compared with an Australian corporation selling

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[5] The producer's state could easily extract taxes from the consumer in exchange for benefits by charging a sales tax at the point of origin which the customer would pay to the producer.

[6] *See, e.g.*, Convention for the Avoidance of Double Taxation, Aug. 6, 1982, U.S.-Aus., art. V and VII, available at http://www.irs.gov/pub/irs-trty/aus.pdf.

in the United States. Though U.S. tax treaties do not apply to sub-national taxes (e.g., state taxes), as a practical matter it is more difficult to enforce tax collection judgments against foreign-based corporations. Furthermore, since many states conform to the Internal Revenue Code and use federal income as a starting point for state income, many if not most foreign-based multinationals without a permanent establishment in a state will rightly claim zero income on their state returns.

Table 3: Economic Presence Leads to Tax Inequity between U.S.-Based and Foreign-Based Multinationals

	Australia-Based Corporation	***California-Based Corporation***
Activities in Maine	Selling goods and services	Selling goods and services
Federal Taxes Due?	No	Yes
Rationale	U.S.-Australia tax treaty requires permanent establishment	Treaty does not apply to U.S.-based company; sales enough to trigger taxation under economic presence
Maine State Taxes Due?	Yes	Yes
Rationale	State law (economic presence)	State law (economic presence)
Likelihood of Maine Collecting Tax from Corporation	Unlikely (due to administrative difficulties of enforcing judgments and the reliance on federal income tax base)	More likely

The result of a widespread economic presence standard would thus clearly disadvantage U.S.-based firms compared with their foreign-based competitors. In the expanding global marketplace, this is hardly the right policy choice to promote U.S. competitiveness.

Conclusion

U.S. corporations should only pay business activity taxes in those states in which they are physically present. The physical presence rule is fair to businesses since it requires tax in exchange for government-provided benefits in every state where companies employ labor and capital. Physical presence is also more consistent with the language in U.S. tax treaties and thus creates more equity between U.S.-based and foreign-based corporations doing business in the U.S. The physical presence standard also has other benefits, including the promotion of a robust interstate market,[7] maintenance of state tax competition and the reduction in the number of states in which corporations have to pay tax.[8] For these reasons, Congress should consider moving ahead with the adoption of a physical presence standard for state business activity taxes.

(For more information, please contact Chris Atkins at (202) 464-6200.)

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[7] *See* 108th Cong., 2d Sess. 35 (2004) (letter of Bo Horne) ("We have become so concerned about the risk of our continued participation in Interstate Commerce that we have begun to ask ourselves 'Why bother? Can we afford this risk? Should we terminate the business before it gets worse?'").

[8] *See* Chris Atkins, "A Twentieth Century Tax in the Twenty-First Century: Understanding Multistate Corporate Tax Systems," Tax Foundation *Background Paper* No. 49 (September, 2005).

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