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BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2008

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

H.R. 5267

JUNE 24, 2008

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BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2008

TUESDAY, JUNE 24, 2008

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

The Subcommittee met, pursuant to notice, at 1:10 p.m., in room 2237, Rayburn House Office Building, the Honoorable Linda Sánchez (Chairwoman of the Subcommittee) presiding.

Present: Representatives Conyers, Sánchez, Johnson, Lofgren, Delahunt, Smith, Jordan, and Feeney.

Staff present: Norberto Salinas, Majority Counsel; Stewart Jeffries, Minority Counsel; and Adam Russell, Majority Professional Staff Member.

Ms. SÁNCHEZ. This hearing of the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law will now come to order.

Without objection, the Chair will be authorized to declare a recess of the hearing at any point.

I am now going to recognize myself for a short statement.

The growth of marketing and sales of goods and services over the Internet is just one example of our country's movement toward an economic system not limited by State borders.

But this borderless economy has led to confusion for some businesses regarding their tax obligations. Although a State levies taxes on companies conducting business within the State, some companies have expressed concerns that they are unaware when their activities trigger State tax obligations.

These companies favor a physical presence standard for taxation. In essence, the standard would require businesses to pay taxes to States in which they own or lease property or effectively station employees.

On the opposing side are the State governments. They oppose such an approach contending that, in the future, because more transactions and services will occur online, the physical presence standard would eviscerate State revenues and prompt tax avoidance schemes.

The question then becomes how do you clarify the taxation standard while protecting State revenues and taxing authorities.

The legislation we are examining today is H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

[The bill, H.R. 5267, follows:]

I

110TH CONGRESS
2D SESSION

H. R. 5267

To regulate certain State taxation of interstate commerce, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 7, 2008

Mr. BOUCHER (for himself, Mr. GOODLATTE, Mr. DAVIS of Alabama, Mr. CHABOT, Ms. HERSETH SANDLIN, Mr. FEENEY, Ms. JACKSON-LEE of Texas, Mr. GALLEGLY, Mr. JOHNSON of Georgia, Mr. PENCE, Ms. ZOE LOFGREN of California, Mr. SCOTT of Virginia, and Mr. WEXLER) introduced the following bill; which was referred to the Committee on the Judiciary

---

A BILL

To regulate certain State taxation of interstate commerce, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Business Activity Tax Simplification Act of 2008".

SEC. 2. MODERNIZATION OF PUBLIC LAW 86–272.

(a) SOLICITATIONS WITH RESPECT TO SALES AND TRANSACTIONS OF OTHER THAN TANGIBLE PERSONAL

PROPERTY.—Section 101 of the Act entitled "An Act relating to the power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto", approved September 14, 1959 (15 U.S.C. 381 et seq.) is amended—

(1) in section (a), by striking "either, or both," and inserting "any one or more";

(2) in subsection (a)(1), by striking "by such person" and all that follows and inserting "(which are sent outside the State for approval or rejection) or customers by such person, or his representative, in such State for sales or transactions, which are—

"(A) in the case of tangible personal property, filled by shipment or delivery from a point outside the State; and

"(B) in the case of all other forms of property, services, and other transactions, fulfilled or distributed from a point outside the State;";

(3) in subsection (a)(2), by striking the period at the end and inserting a semicolon;

(4) in subsection (a), by adding at the end the following new paragraphs:

"(3) the furnishing of information to customers or affiliates in such State, or the coverage of events

or other gathering of information in such State by such person, or his representative, which information is used or disseminated from a point outside the State; and

"(4) those business activities directly related to such person's potential or actual purchase of goods or services within the State if the final decision to purchase is made outside the State.";

(5) by striking subsection (c) and inserting the following new subsection:

"(c) For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely—

"(1) by reason of sales or transactions in such State, the solicitation of orders for sales or transactions in such State, the furnishing of information to customers or affiliates in such State, or the coverage of events or other gathering of information in such State, on behalf of such person by one or more independent contractors;

"(2) by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales or fulfilling

transactions, soliciting order for sales or transactions, the furnishing of information to customers or affiliates, or the coverage of events or other gathering of information; or

"(3) by reason of the furnishing of information to an independent contractor by such person ancillary to the solicitation of orders or transactions by the independent contractor on behalf of such person."; and

(6) in subsection (d)(1)—

(A) by inserting "or fulfilling transactions," after "selling"; and

(B) by striking "the sale of, tangible personal property" and inserting "a sale or transaction, furnishing information, or covering events, or otherwise gathering information".

(b) APPLICATION OF PROHIBITIONS TO OTHER BUSINESS ACTIVITY TAXES.—Title I of the Act entitled "An Act relating to the power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto", approved September 14, 1959, (15 U.S.C. 381 et seq.) is amended by adding at the end the following:

"SEC. 105. For taxable periods beginning on or after January 1, 2009, the prohibitions of section 101 that apply with respect to net income taxes shall also apply with respect to each other business activity tax, as defined in section 3(g) of the Business Activity Tax Simplification Act of 2008. A State or political subdivision thereof may not assess or collect any tax which by reason of this section the State or political subdivision may not impose.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the imposition, assessment, and collection of taxes for taxable periods beginning on or after January 1, 2009.

SEC. 3. MINIMUM JURISDICTIONAL STANDARD FOR STATE AND LOCAL NET INCOME TAXES AND OTHER BUSINESS ACTIVITY TAXES.

(a) IN GENERAL.—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.

(b) REQUIREMENTS FOR PHYSICAL PRESENCE.—

(1) IN GENERAL.—For purposes of subsection (a), a person has a physical presence in a State only

if such person's business activities in the State include any of the following during such person's taxable year:

(A) Being an individual physically in the State, or assigning one or more employees to be in the State.

(B) Using the services of an agent (excluding an employee) to establish or maintain the market in the State, if such agent does not perform business services in the State for any other person during such taxable year.

(C) The leasing or owning of tangible personal property or of real property in the State.

(2) DE MINIMIS PHYSICAL PRESENCE.—For purposes of this section, the term "physical presence" shall not include—

(A) presence in a State for less than 15 days in a taxable year (or a greater number of days if provided by State law); or

(B) presence in a State to conduct limited or transient business activity.

(c) TAXABLE PERIODS NOT CONSISTING OF A YEAR.—If the taxable period for which the tax is imposed is not a year, then any requirements expressed in days

for establishing physical presence under this Act shall be adjusted pro rata accordingly.

(d) MINIMUM JURISDICTIONAL STANDARD.—This section provides for minimum jurisdictional standards and shall not be construed to modify, affect, or supersede the authority of a State or any other provision of Federal law allowing persons to conduct greater activities without the imposition of tax jurisdiction.

(e) EXCEPTIONS.—

(1) DOMESTIC BUSINESS ENTITIES AND INDIVIDUALS DOMICILED IN, OR RESIDENTS OF, THE STATE.—Subsection (a) does not apply with respect to—

(A) a person (other than an individual) that is incorporated or formed under the laws of the State (or domiciled in the State) in which the tax is imposed; or

(B) an individual who is domiciled in, or a resident of, the State in which the tax is imposed.

(2) TAXATION OF PARTNERS AND SIMILAR PERSONS.—This section shall not be construed to modify or affect any State business activity tax liability of an owner or beneficiary of an entity that is a partnership, an S corporation (as defined in section

1361 of the Internal Revenue Code of 1986), a limited liability company (classified as a partnership for Federal income tax purposes), a trust, an estate, or any other similar entity, if the entity has a physical presence in the State in which the tax is imposed.

(3) PRESERVATION OF AUTHORITY.—This section shall not be construed to modify, affect, or supersede the authority of a State to bring an enforcement action against a person or entity that may be engaged in an illegal activity, a sham transaction, or any perceived or actual abuse in its business activities if such enforcement action does not modify, affect, or supersede the operation of any provision of this section or of any other Federal law.

(f) RULE OF CONSTRUCTION.—This section shall not be construed to modify, affect, or supersede the operation of title I of the Act entitled "An Act relating to the power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto", approved September 14, 1959 (15 U.S.C. 381 et seq.).

(g) DEFINITIONS, ETC.—For purposes of this section:

(1) NET INCOME TAX.—The term "net income tax" has the meaning given that term for the purposes of the Act entitled "An Act relating to the

power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto", approved September 14, 1959 (15 U.S.C. 381 et seq.).

(2) OTHER BUSINESS ACTIVITY TAX.—

(A) IN GENERAL.—The term "other business activity tax" means any tax in the nature of a net income tax or tax measured by the amount of, or economic results of, business or related activity conducted in the State.

(B) EXCLUSION.—The term "other business activity tax" does not include a sales tax, a use tax, or a similar transaction tax, imposed on the sale or acquisition of goods or services, whether or not denominated a tax imposed on the privilege of doing business.

(3) PERSON.—The term "person" has the meaning given such term by section 1 of title 1 of the United States Code.

(4) STATE.—The term "State" means any of the several States, the District of Columbia, or any territory or possession of the United States, or any political subdivision of any of the foregoing.

1 (5) TANGIBLE PERSONAL PROPERTY.—For pur-
2 poses of subsection (b)(1)(C), the leasing or owning
3 of tangible personal property does not include the
4 leasing or licensing of computer software.
5 (h) EFFECTIVE DATE.—This section shall apply with
6 respect to taxable periods beginning on or after January
7 1, 2009.

○

Ms. SÁNCHEZ. This bill would prohibit State taxation of interstate commerce of out-of-state transactions involving all forms of property.

The legislation would also establish the physical presence standard advocated by business interests.

This afternoon's hearing serves a dual purpose. First, this hearing provides us with the opportunity to learn more about business activity taxes and under what circumstances they are levied.

Second, the testimony provided today will help us determine what role Congress has in this matter and whether H.R. 5267 addresses the concerns of businesses that are expected to pay these types of taxes while also protecting the interests of State governments to tax business activity within their borders.

To help us explore these issues, we have six witnesses divided into two panels for this hearing.

For our first panel, we have Representatives Rick Boucher from the 9th District of Virginia and Bob Goodlatte from the 6th District of Virginia, the authors of the legislation. And they will discuss H.R. 5267.

For our second panel, I am pleased to have Mark Ducharme, vice president and CFO of Monterey Boats; R. Bruce Johnson, commissioner of the Utah State Tax Commission; Michael Petricone, vice president of technology policy at the Consumer Electronics Association; and David Quam, director of Federal relations at the National Governors' Association.

As we hear today's testimony, let us remember that we must balance the interests of State governments to collect revenue with efforts to encourage business development.

Accordingly, I look forward to this afternoon's hearing and see it as the beginning of a dialogue on this issue.

I now would like to recognize my colleague, Mr. Jordan, our acting Ranking Member of the Subcommittee for any opening remarks he may have.

Mr. JORDAN. Thank you, Madam Chair.

Ranking Member Cannon is unable to make the hearing today because of the Utah primary. He extends his regrets.

Today we consider H.R. 5267, the "Business Activity Tax Simplification Act of 2008," a measure intended to provide greater clarity to businesses in navigating the tax landscape.

This bill was introduced by Representative Rick Boucher on February 26, 2008, and has 26 co-sponsors.

Representative Bob Goodlatte, who sponsored similar measures in previous Congresses, is the primary Republican co-sponsor of the legislation.

H.R. 5267 is designed to address a fundamental problem relating to interstate commerce. Specifically, when is a State justified in taxing a business with little or no physical connection with the State?

Congress has examined this issue from time to time over the years. Now, with the emergence of the Internet economy and the explosion of the service industries, the need for clear, concise taxation standards has become even more urgent.

In 1995, Congress enacting Public Law 86-272, still enforced 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.

In addition, since 1959, many States appear to have engaged in practices that are at odds with the meaning and the intent of Public Law 86-272.

For example, States have begun to impose a tax on companies 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, litigate the appropriate nexus standard for business activity taxes.

H.R. 5267 would provide some certainty to this issue. It would amend Public Law 86-272 to be able 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 bright line 15-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 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, 108th, and 109th Congresses, Subcommittee considered similar measures sponsored by 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, the Subcommittee did not have an opportunity to consider the bill further after a legislative hearing.

And in the 109th Congress, the bill was favorably reported out of the Committee by voice vote but was not considered by the full House.

I would note that supporters of this legislation have made a number of changes from previous versions in order to make the bill more palatable to the States.

One such change was reducing the period of time that triggered tax liability from 21 days to 15. This bill also eliminates the number of exceptions to the physical presence test that were contained in earlier versions.

As always, this bill enjoys wide support in the business community, including the Business Roundtable, the National Association of Manufacturers, the Motion Picture Association of America, and the Software and Information Industry Association, to name only a few.

I recognize that the States continue to have a number of concerns about the legislation, both in terms of how it will impact their bottom line and its encroaching into traditional State taxation authorities.

I hope that this hearing can begin a dialogue where both sides can try to reach an accommodation on this important issue for American businesses.

I look forward to hearing from all our witnesses today.

Thank you, Madam Chair.

Ms. SÁNCHEZ. Thank you. I thank the gentleman for his statement, and I would like to recognize Mr. Smith, the distinguished Ranking Member of the Committee on the Judiciary for an opening statement if he wishes.

Mr. SMITH. Thank you, Madam Chair.

First of all, I want to thank our colleagues from the Judiciary Committee, Congressman Boucher and Congressman Goodlatte, for introducing this piece of legislation.

It is nice to see two Members of the Committee and two Virginians linking arms to pass such a good piece of legislation.

H.R. 5267, the Business Activity Tax Simplification Act of 2008, creates a physical presence requirement before State governments can collect income taxes or other business activity taxes on companies that conduct businesses in their States.

Without such a physical presence requirement, companies must contend with dozens of different rules for determining when they owe State business activity taxes.

The Business Activity Tax Simplification Act brings the law regarding business activity tax into line with the physical presence standard that Congress adopted for State sales taxes in 1959.

This bill would list those conditions that a business must meet to establish a physical presence for the purposes of the imposition of a business activity tax by States.

I supported similar legislation in the past because I think that businesses deserve some clarity as to when they will owe corporate income taxes.

This bill also will make it easier for small businesses to determine their tax liability, and it will also limit the imposition of taxes for the simple act, for example, of driving goods across a State's highways.

This legislation has tremendous support in the business community.

We have received over 20 statements for the record in support of this legislation from business associations both large and small.

At the same time, I recognize that some States have concerns about this legislation because of its impact on potential revenue.

I know this Subcommittee has a history of asking the States and business stakeholders to sit down and talk about their differences when it comes to taxation, so I hope similar such talks can occur in the future about this legislation.

And with that, Madam Chair, I will yield back.

Thank you for yielding.

Ms. SÁNCHEZ. I thank the gentleman for his statement.

Without objection, other Members' opening statements will be included in the record.

[The prepared statement of Mr. Conyers follows:]

PREPARED STATEMENT OF THE HONORABLE JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN, CHAIRMAN, COMMITTEE ON THE JUDICIARY, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

While Congress must ensure that the States do not burden interstate commerce through their taxing authority, the authority of States to tax activity within their

borders must be respected. Clearly, we must carefully balance these competing interests.

Today, we will consider H.R. 5267, the "Business Activity Tax Simplification Act of 2008," which attempts to clarify when a State may tax a business with little or no physical connection with the State.

The bill establishes a physical presence standard for business activity taxes, and amends Public Law 86–272 to protect from State net income tax obligations the solicitation of orders of all forms of property and services, not just tangible property.

Establishing a uniform standard would potentially create certainty for businesses and State governments. The business community could presumably better plan its development by knowing when and where it is obligated to pay taxes.

Imposing a physical presence standard, however, could drastically alter the taxing landscape. States now generally apply an economic presence standard, whereby a company is taxed based on whether it conducts business within the State.

In this precarious economic environment, where State revenues are already in decline, we should be very careful in considering legislation that could further impact State revenues or present tax avoidance possibilities.

At least with respect to legislation that was similar to H.R. 5267, it was estimated that lost State tax revenues could be as high as $8 billion in the first year following enactment.

I think we need to look carefully at this bill to see if it might have a similar negative impact on the States.

I look forward to today's hearing, and hope it will achieve three critical objectives.

First, it should serve as a robust venue where the current standard of economic presence, the extent of confusion presented by the current standard, and the bona fides of a new standard that would permit a State to tax only companies with a physical presence there can be thoroughly examined.

Second, this hearing should allow us to focus on H.R. 5267, which responds to concerns put forward by the business community regarding confusing State tax obligations.

Third, this hearing should serve to begin a dialogue on State business activity taxes that results in a standard that is predictable, respects State taxing authority, and provides for a balanced and fair tax system.

I thank Chairwoman Sánchez for holding this important hearing, and I very much look forward to hearing today from the witnesses.

[The prepared statement of Mr. Cohen follows:]

PREPARED STATEMENT OF THE HONORABLE STEVE COHEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

The issue that H.R. 5267, the "Business Activity Tax Simplification Act," seeks to address is a complex one. What is the proper scope of a state's authority to tax the business activity of an interstate business? Unfortunately, the Supreme Court has provided ambiguous guidance with respect to the constitutionally required nexus between a state and an interstate business that is needed for the state to be able to impose a business activity tax.

H.R. 5267 is supposed to answer this question in favor of a "physical presence" nexus requirement and a limited definition of taxable business activity. Proponents of this bill contend that they seek uniformity and clarity with respect to the state tax obligations of businesses, and that the current patchwork of state and local tax laws concerning business activity places an unsustainable and impermissible burden on interstate commerce. Opponents, meanwhile, maintain that this bill, if enacted as written, would cost financially strapped states like Tennessee billions of dollars in lost tax revenue, and that will have a negative impact on state government services and employees. I do not see H.R. 5267 as the final answer to the issue of states' authority to impose business activity taxes. Rather, I hope that all the stakeholders will use this opportunity to engage in an honest and open discussion amongst them so as to reach consensus on establishing a clear and uniform standard with respect to business activity taxes.

[The prepared statement of Mr. Franks follows:]

PREPARED STATEMENT OF THE HONORABLE TRENT FRANKS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA, AND MEMBER, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

Thank you, Madam Chair, for holding this critically important hearing on the "Business Activity Tax Simplification Act of 2008." I would also like to express my appreciation to the witnesses for joining us here today to discuss this legislation.

It is rare in this 110th Congress that a proposed law has drawn such diverse support across party lines. A brief glance at this legislation's cosponsors reveals some of the most ardent conservatives lining up with the most passionate liberals in support of this bill. It is equally rare in this Congress that a law has been considered which makes government less intrusive, business easier, and regulations clearer. Metaphorically, this bill is the white whale of this session. With bipartisan cooperation and sound policy, it unquestionably deserves the full backing of this subcommittee.

First, I would like to address the concerns of the states, the most visible opponents of this legislation. They claim that the "Business Activity Tax Simplification Act of 2008" passes an unfunded mandate onto state governments. This mandate, according to the states, comes at an especially difficult financial time for their budgets. Yet financial irresponsibility on the part of the states does not provide an excuse for their laws to interfere with the flow of interstate commerce. Many studies, such as from the CATO Institute, document the reckless spending binge indulged in by state governments. I do not mean to take the financial problems now faced by the states lightly, but they have no business passing on their burden to the detriment of the national economy. Finally, it appears that the states tend to exaggerate the severity of this legislation's impact on tax revenues. The Tax Foundation notes that the estimated revenue loss for the states under similar legislation authored in the 109th Congress is roughly 0.1 percent, so small that it falls within typical revenue estimate margins of error.

This issue of overreaching state laws is not new. Before the Constitution, the United States was governed under the Articles of Confederation. Under these Articles, the federal government was powerless to ensure that interstate commerce flowed without burdensome impediments. States often engaged in trade wars with each other, grinding national commerce to a halt. As a remedy, the new Constitution drafted by the Founding Fathers gave Congress explicit authority in Article I to regulate commerce "among the several states." This legislation clearly falls under the purview of the Commerce Clause and within Congress' enumerated powers.

With this constitutional authority in mind, the "Business Activity Tax Simplification Act of 2008" modernizes a 49-year-old law to reflect the dramatic changes in the nature of our economy, which is increasingly reliant upon networks that cross state lines. In a time of slowing economic growth, confusing and irrational policies are the last thing that American workers and employers need. Business activity taxes are just that. Haphazardly applied and enforced, they unnecessarily impede the vibrant interstate commerce that fuels our powerful economic engine. As such, Congress has a legitimate and vital responsibility to act.

In establishing guidelines based upon a "physical presence" standard, this legislation gives much-needed legal clarity to small businesses hoping to expand their operations to other states. Some argue that states can work collectively to make their business activity taxes more succinct; yet it is for this very purpose, to address commerce issues that cross state lines, that the federal government exists! I urge all of my colleagues to support this common-sense, bipartisan legislation that protects the interstate economy so vital to the fabric of this nation. Madam Chair, I yield the balance of my time.

I am now pleased to introduce the witnesses on our first panel for today's hearing.

Our first witness is Congressman Rick Boucher.

Mr. Boucher is serving in his thirteenth term in the U.S. House of Representatives and represents Virginia's 9th Congressional District.

Prior to his election to Congress, he served for 7 years as a member of the Virginia State Senate.

He is a native of Abingdon, Virginia.

Congressman Boucher sits on the House Judiciary Committee, serving on the Courts, the Internet, and Intellectual Property Subcommittee.

He also is a Member of the House Energy and Commerce Committee, serving on three Subcommittees: Energy and Air Quality, of which he is the Chairman; as well as Telecommunications and the Internet; and Commerce Trade and Consumer Protection.

As Chairman of the Energy and Air Quality Subcommittee, he is uniquely positioned to influence Federal legislation relating to a broad range of energy-related issues including electricity generation and markets, cool use, pipeline safety, refineries, and the Clean Air Act.

Mr. Boucher is the sponsor of H.R. 5267.

Our second witness is Congressman Goodlatte. Mr. Goodlatte is in his eighth term and represents the 6th Congressional District of Virginia.

Prior to serving in Congress, he was a partner in the law firm of Bird, Kinder, and Huffman.

Congressman Goodlatte also served as district director for former Congressman Caldwell Butler.

Congressman Goodlatte serves on the House Judiciary Subcommittee on Immigration, Citizenship, Refugees, Border Security, and International Law and on the Courts, the Internet, and Intellectual Property Subcommittee.

In addition to serving on the House Judiciary Committee, he serves as the Ranking Republican on the House Agriculture Committee.

Congressman Goodlatte has taken a strong interest in issues such as welfare reform and forestry policy.

Mr. Goodlatte is an original co-sponsor of H.R. 5267.

I want to thank you both for your willingness to participate in today's hearing.

And without objection, your written statements will be placed into the record in their entirety.

And we are going ask that you limit your oral remarks to 5 minutes.

You are, I am sure, more than intimate with the lighting system.

Sometimes, we forget to start it, but you are forewarned.

And, of course, if you are caught mid-sentence or mid-thought when your time expires, we will allow you to complete your thought before moving on.

So with that, I am going to invite Mr. Boucher to please proceed with your testimony.

TESTIMONY OF THE HONORABLE RICK BOUCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. BOUCHER. Chairwoman Sánchez, thank you very much for holding this hearing on what Bob and I both believe is a timely subject and, according to both of us, an opportunity to comment on the legislation that together we have introduced.

We have been partnered in this exercise for many years, and continue to believe that this measure deserves passage and would commend it to the Subcommittee's consideration.

I would note this afternoon that the measure is co-sponsored by 26 Members of the House.

And I will just take a moment to list of Members of the House Judiciary Committee who, on a bipartisan basis, are supporting the legislation.

Representatives Hank Johnson, Bobby Scott, Zoe Lofgren, Arthur Davis, Sheila Jackson Lee, Bob Wexler, Anthony Weiner, Elton Gallegly, Steve Chabot, Mike Pence, and Tom Feeney.

So we do have, essentially, equal numbers of Democrats and Republicans on the full Committee co-sponsoring this measure.

It is an urgently-needed modernization of a 49-year-old statute that determines when States can impose State income taxes on the sales of tangible personal property within that State.

Reflecting the economy of its time, that five-decade-old statute only applies to State income taxes, and it only applies to the sales of tangible personal property.

Over the years, States have adopted a series of business activity taxes that, in some respects, are proxies for the State income tax including, among others, gross receipts taxes and a range of license arrangements.

And the States frequently seek to impose those taxes on out-of-state companies that have no physical presence within the State.

And over the years, greater volumes of our national commerce have been in intangible products and services such as financial services and software.

Our measure modernizes the old law by expanding it to address not just State income taxes but also that range of business activity taxes that serve as proxies in some cases for the State income taxes.

And we also create situations where there is a more explicit bright-line standard for the circumstances in which those taxes can be imposed.

For 49 years, the test has been whether or not an out-of-state company has a physical presence within the taxing State.

We keep that standard, but we provide a much clearer definition of what constitutes a physical presence.

The bill provides certainty for the States and for out-of-state companies alike by specifying that physical presence means having property or employees within the taxing State for at least days within a year.

If that test is met, State business activity taxes can be imposed on the sales that take place within that State.

In the absence of these needed changes, the current legal uncertainty is producing clearly undesirable result.

And I will just mention several examples.

In Louisiana, the threat of business activity taxes has been raised against companies that have no physical presence within the State but broadcast advertisements from out-of-state into the State of Louisiana.

Several States have attempted to impose business activity taxes on credit card companies located outside the State based solely on the fact that in-state residents are subscribers to those credit card services.

New Jersey has held trucks belonging to companies with no physical presence in New Jersey that were passing through the State in order to make deliveries in another State until business activity taxes sometimes ranging in the tens of thousands of dollars have been paid.

Many other equally troubling examples could be cited, and I think some witnesses, perhaps, will mention some of them.

Our legislation is a needed modification of an old law which is appropriate to the realities of today's national commerce.

If offers a certainty that should be welcome to companies doing business across State lines and to the taxing authorities at the State level alike.

I very much appreciate the Chairwoman's focus on this timely matter, her very balanced statement, and her indication of welcoming our views and a continued discussion on this subject.

We very much look forward to working with you and the other Members of the Committee as your considerations continue.

At the end of that process, it is very much our hope that we will be able to pass a law which provides a much-needed modernization of the term under which State business activity taxes can be imposed on out-of-state companies of them.

Thank you very much, Madam Chairwoman.

[The prepared statement of Mr. Boucher follows:]

PREPARED STATEMENT OF THE HONORABLE RICK BOUCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Chairwoman Sánchez, I appreciate your conducting today's hearing on the Business Activity Tax Simplification Act, which I introduced with my Virginia colleague Bob Goodlatte.

The measure is cosponsored by 26 House Members, including our Committee colleagues Hank Johnson, Bobby Scott, Zoe Lofgren, Artur Davis, Sheila Jackson Lee, Bob Wexler, Anthony Weiner, Elton Gallegly, Steve Chabot, Mike Pence, and Tom Feeney.

It is an urgently needed modernization of the 49-year-old federal statute that determines when states can impose state income taxes on the sale of tangible personal goods in the state.

Reflecting the economy of its time, that five decade old law only applies to state income taxes and only to the sale within the state of tangible personal property.

Over the years, states have adopted a series of business activity taxes that are proxies for the state income tax, including gross receipts taxes, licensing arrangements, and other charges which states frequently seek to impose on out of state companies.

And over the years, greater volumes of our national commerce have been in intangible products and services, such as financial services and software.

Our measure modernized the old law by expanding it to address not just state income taxes but business activity taxes as well.

We also make the circumstances under which these taxes can be imposed on out of state companies explicit with a bright line standard.

For 49 years the test has been whether the out of state company has a physical presence in the taxing state.

We keep that standard, but we provide a clearer definition of what constitutes physical presence. The bill provides certainty for the states and out of state companies alike by specifying that physical presence means having property or employees in the state for at least 15 days annually. If that test is met, state business activity taxes can be imposed on the sales that take place in the state.

In the absence of these needed changes, the current legal uncertainty is producing undesirable results.

In Louisiana, the threat of business activity taxes has been raised against companies that have no physical presence in the state but broadcast advertisements into the state from out of state.

Several states have attempted to impose business activity taxes on credit card companies located outside the state, based solely on the fact that in state residents subscribe to the credit cards.

New Jersey has held trucks belonging to companies with no physical presence in New Jersey that were passing through the state to make deliveries in another state until business activity taxes of tens of thousand of dollars were paid.

Many other equally troubling examples can be cited.

Our legislation is a needed modification of an old law which is appropriate to the realities of today's national commerce. It offers a certainty that should be welcome to both companies doing business across state lines and state taxing authorities alike.

I appreciate the Committee's focus on this timely matter and look forward to working with you as we take further steps.

Ms. SÁNCHEZ. Thank you, Mr. Boucher. We appreciate your testimony.

At this time, I would invite Mr. Goodlatte to proceed with his testimony.

TESTIMONY OF THE HONORABLE BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. GOODLATTE. Well, thank you, Madam Chairman. I appreciate the opportunity to testify. I appreciate your holding this hearing and your and the other Members of the Committee's interest in this important legislation.

Many States and some local governments levy corporate income, franchise, and other taxes on out-of-state companies that conduct business activities within their jurisdiction.

While providing revenue for States, these taxes also serve to pay for the privilege of doing business in a State.

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 basis 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.

I understand that some of our witnesses on the next panel will detail the specific examples of abuses that are occurring under the current ambiguous legal environment.

Previous actions by the Supreme Court and Congress have laid the ground work for a clear, concise, and modern bright-line 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 purposes of imposing business activity taxes.

In addition, over 40 years ago, Congress passed legislation to prohibit jurisdictions from taxing the income of out-of-state corporations whose in-state presence was nominal.

Public Law 86-272 set clear, uniformed standards for when States could and could not impose such taxes on out-of-state businesses when the business activities involved 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 of 2008 both modernizes and provides clarity to an outdated and ambiguous tax environment.

First, the legislation updates the protections of P. L. 86-272.

This legislation reflects the changing nature of our economy by expanding the scope of protections of that law from just tangible personal property to include intangible property and services.

In addition, our legislation sets forth clear, specific standards to govern when businesses should be obligated 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 corporate net income taxes and other types of business activity taxes.

The clarity that the Business Activity Tax Simplification Act will bring with insure fairness, minimize litigation, and create the kind of legally certain and stable business 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 the States to ensure that they are fairly compensated when they provide services to businesses that do have a physical presence in the State.

H.R. 5267 has been amended from what the Judiciary Committee reported out by voice vote last Congress.

Specifically, the legislation has been amended to address some of the concerns expressed by the States.

For example, the time period during this an individual or business could be present in a State without constituting a substantial physical presence has been reduced from 21 days to 14 days.

I will end my testimony by mentioning that this legislation has strong bipartisan support as noted by my colleague and friend, Congressman Boucher, from numerous Members of the House Judiciary Committee.

And I would strongly urge the Chairman of the Subcommittee and Chairman Conyers to move forward with the markup of this legislation in the near future.

And I thank you again for allowing me to participate today.

[The prepared statement of Mr. Goodlatte follows:]

PREPARED STATEMENT OF THE HONORABLE BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Madam Chairman and Ranking Member Cannon, thank you for inviting me to testify this afternoon about the Business Activity Tax Simplification Act.

Many states and some 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 and interstate business-to-business and business-to-consumer transactions raise questions over where multi-state 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. I understand that some of our witnesses on the next panel will detail the specific examples of abuses that are occurring under the current ambiguous legal environment.

Previous actions by the Supreme Court and Congress have laid the groundwork for a clear, concise and modern "bright line" rule in this area. In the landmark case of Quill Corp. 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 Asubstantial nexus@ with the taxing state. However, the Court did not define what constituted a "substantial nexus" for purposes of imposing business activity taxes.

In addition, over forty years ago, Congress passed legislation to prohibit jurisdictions 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 businesses' activities involved 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 forty years, and this outdated statute needs to be modernized.

The Business Activity Tax Simplification Act of 2008 both modernizes and provides clarity to an outdated and ambiguous tax environment. First, the legislation updates the protections in P.L. 86–272. This legislation reflects the changing nature of our economy by expanding the scope of the protections in P.L. 86–272 from just tangible personal property to include intangible property and 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 corporate net income taxes and other types of 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 business 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 provide services to businesses that do have a physical presence in the state.

H.R. 5267 has been amended from what the Judiciary Committee reported out by voice vote last Congress. Specifically, the legislation has been amended to address some of the concerns expressed by the States. For example, the time period during which an individual or business could be present in a State without constituting a substantial physical presence has been reduced from 21 days to 14 days.

I will end my testimony by mentioning that this legislation has strong bipartisan support from numerous Members of the House Judiciary Committee. I would strongly urge the Chairman of the Subcommittee and Chairman Conyers to move forward with a markup of this legislation in the near future.

Ms. SÁNCHEZ. We thank you for your testimony, Mr. Goodlatte.

At this time, it is traditional to begin a round of questioning. I don't have any questions for the first panel.

I am going to encourage my colleagues not to ask too many questions of the first panel knowing that your schedules, probably, are just as busy as ours.

But if anybody is interested in asking brief questions? No? Nobody? Nope.

The gentlewoman from California, Ms. Zoe Lofgren, is recognized.

Ms. LOFGREN. Not a question, but just kudos to our colleagues on the Committee for the leadership they have shown on this, not just this year, but in past years.

I really appreciate and am proud to be a co-sponsor.

Thank you.

Ms. SÁNCHEZ. Anybody else?

Okay. Gentlemen, that is it. We thank you for your testimony, and you are excused to run off to the many other demands on your time I am sure that you have.

Mr. BOUCHER. Thank you, Madam Chairwoman.

Ms. SÁNCHEZ. At this time, I would invite the second panel of witnesses to please approach the table.

It is now my pleasure to introduce our second panel of witnesses for today's hearing.

Our first witness is Mark Ducharme. And I apologize; I mispronounced your name initially.

Mr. Ducharme is the vice president and chief financial officer of Monterey Boats, a Gainesville, Florida company founded in 1985.

Prior to his employment at Monterey Boats, he served at James Moore and Company from 1995 to 1999, and at Arthur Anderson, LLP from 1989 to 1995.

Mr. Ducharme is a member of the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants, and the board of directors of Big Brothers-Big Sisters of Mid-Florida.

We want to welcome you to today's panel.

Our second witness is Bruce Johnson, commissioner for the Utah State Tax Commission.

Commissioner Johnson was appointed by Utah Governor Leavitt in 1998.

Prior to his appointment, he was a partner at the law firm of Holme, Roberts, and Owen, LLP, where he litigated State and local tax disputes and advised clients on State and local tax issues, tax exemption issues, and issues relating to tax-exempt municipal financing.

Commissioner Johnson also was a trial attorney for the tax division of the U.S. Department of Justice.

Commissioner Johnson serves on the executive committee of the Streamlined Sales Tax Governing Board and is a member of the Utah Tax Review Commission, and a board member of the National Tax Association.

He is a recent past chair of the American Bar Association Tax Section Committee on State and Local Taxes.

We want to welcome you to our panel, Mr. Johnson.

Our third witness is Michael Petricone.

Mr. Petricone is the senior vice president of governmental affairs for the Consumer Electronics Association. He is responsible for representing the consumer electronics industry's position before Congress and the FCC on critical issues such as digital television, broadband, privacy, and home recording rights.

Mr. Petricone is a frequent speaker on policy issues impacting the consumer electronics industry.

And in 2003, he was featured by "Dealer Scope" magazine as one of the technology industry's top 40 under 40.

Welcome to you, Mr. Petricone.

Our final witness is David Quam, who we recognize. He has been before this Subcommittee many times.

He is the director of the Office of Federal Relations for the National Governor's Association.

Mr. Quam manages the NGA's legal and advocacy efforts, working closely with governors, Washington, DC representatives, and NGA's standing committees to advance the associations legislative priorities.

Prior to working at NGA, Mr. Quam served as director of international affairs and general counsel of the International Anti-Counterfeiting Coalition, Incorporated.

He was also an associate of the law firm of Powell, Goldstein, Frazer, and Murphy, LLP.

Additionally, Mr. Quam was counsel on the U.S. Senate Subcommittee on the Constitution, Federalism, and Property Rights for the Committee on the Judiciary.

It is good to have you back again with us, Mr. Quam.

The lighting system, I would explain for this panel because I didn't for the first.

When you begin your oral testimony, you will see a green light. That green light tells you you have 5 minutes to speak.

When you have 1 minute remaining, the light will turn from green to yellow. That warns you that you have 1 minute left.

And, of course, when your time expires, you will see a red light.

If you are caught mid-sentence or mid-thought when the light turns red and your time expires, we will allow you to finish that thought or sentence before we move on.

So with that, I also will tell the witnesses that once you have given us your oral testimony, Members will be allowed to ask question subject to the 5-minute limit.

So with that, I am going to ask Mr. Ducharme to please proceed with his testimony.

TESTIMONY OF MARK DUCHARME, VICE PRESIDENT AND CFO, MONTEREY BOATS, WILLISTON, FL

Mr. DUCHARME. Thank you for the opportunity to address the Subcommittee concerning the Business Activity Tax Simplification Act.

Monterey Boats is a small fiberglass boat manufacturer located in Williston, Florida.

We build boats 18 to 40 feet. We have approximately 550 employees, and produce approximately 2500 units every year.

In understanding and discussing our position on State taxing authority, our obligation to pay appropriately mandated taxes are not in question.

However, our ability to compete in our industry requires us to pass along these costs in the pricing of our product.

When the taxing arm of each State does not consistently apply the law or provide clear guidance on activities requiring registration as an out-of-state corporation and potential tax obligation, we

are at a distinct disadvantage not only with the domestic manufacturers but foreign manufacturers as well.

Our first experience with State nexus in Michigan. The State sent us a detailed questionnaire inquiring about our activities within the State.

Being unfamiliar with the nexus standards and naivete regarding the State's agenda, we inquired to other boat manufacturers their experience with States assessing income and sales tax on out-of-state corporations.

Some manufacturers had not received any contact from States. Others had similar experiences that we were having. And still others received inquiries from States we had no contact with.

Since we do not have property or payroll and sales occur outside the State, we deemed our exposure to Michigan assessing tax nonexistent.

However, in further discussions with Michigan state agents, very few follow-up questions were asked regarding our responses to the questionnaire as if the question on whether or not we owed Michigan's single business tax was a foregone conclusion and the questionnaire with a formal process having little significance in determining whether or not we owed any tax.

We subsequently determined agents from the State were contacting dealers domiciled in the State posing as interested customers to inquire regarding how we delivered the product.

Did we have sales representatives in the State?

How often did they visit the dealer?

Do we assist in unloading the product?

And how was the warranty process handled?

Based on the dealer's responses, it was deemed by the State we had an obligation to register, pay tax, and the burden was on us to disprove comments made by Monterey Boats' dealers regardless of whether or not the dealer could have made incorrect responses, didn't understand the basis of the questions, or confused us with one of the their other product lines.

Our next experience occurred with the State of New Jersey and is nothing short of extortion.

We received a phone call on October 6, 2004 from someone purporting to be an agent with the New Jersey Division of Taxation. The agent indicated he was in possession of our truck with a load of boats destined for delivery in the State.

The agent subsequently indicated the truck was to be impounded along with the boats unless we immediately remitted $27,500.

The investigative agent claimed nexus arose because we deliver product into the State on trucks owned by Monterey.

We also determined the $27,500 figure was determined based on a fuel formula having no basis or relation to property, payroll, or sales.

After refusing to remit any funds for tax based on a fuel formula, we retained an attorney to intervene on our behalf, and our attorney negotiated the release of the truck and the boats.

However, on October 7, we received a warrant of execution jeopardy assessment demanding payment for $176,000, again, based on some explainable fuel formula.

In addition, the State placed a lien by levy on fund due to us from New Jersey dealers finance company.

And on December 21, 2004, we filed a petition on protest and request for refund with the conference and appeals branch with the State.

We received a notification letter and a list of questions the State wanted us to provide prior to the hearing.

None of the questions related to use of or delivery of the boats on Monterey owned or leased trucks appearing as if of reason for New Jersey having authority to impose tax for delivery on product on Monterey trucks no longer applied.

In October 2006, we met with the conference and appeals branch to resolve the issue and clarify our responsibility with the State. Subsequent to that hearing, we submitted a proposed resolution, and to date, no response has been received.

Our sales are down approximately 13 percent year-to-date. Our full-time employee count is down approximately 15 percent.

We are experiencing an unprecedented amount of pricing pressure in the boating industry requiring us to offer higher and more incentives.

In the short term, we consider rebates and incentives in investment in establishing or increasing our market share.

However, in the long term, the continued pressure on profitability has consequences: profound layoffs, decreased competition, and eventually going out of business.

Monterey is the largest employer in the surrounding geographic area and the loss of jobs has a profound and rippling affect through the local economy.

In order to establish consistent application of doing business, we need clear guidance provided by the Business Activity Tax Simplification Act of 2008.

Thank you.

[The prepared statement of Mr. Ducharme follows:]

PREPARED STATEMENT OF MARK DUCHARME

United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

June 24, 2008

State Nexus Testimony

Ms. Chairwoman and Members of the Subcommittee, thank you for holding a hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

In understanding and discussing our position on state taxing authority our obligation to pay appropriately mandated taxes are not in question, however, our ability to compete in our industry requires us to pass along these costs in the pricing of our product. When the taxing arm of each state does not consistently apply the law or provide clear guidance on activities requiring registration as an out of state corporation and potential tax obligation we are at a distinct disadvantage, not only with domestic manufacturer's but foreign manufacturer's as well.

Our first experience with state Nexus occurred in Michigan. State sent us a detailed questionnaire inquiring about our activities within the state. Being unfamiliar with Nexus issue and naïve regarding the state's agenda, we inquired to other boat manufacturer's their experience with state's assessing income and sales tax on out of state corporations. Some manufacturer's had not received any contact from states, others had similar experience and still others received inquiries from states we had no contact with. Since we do not have property or payroll and sales occur outside the state, we deemed our exposure to Michigan assessing tax non-existent. However, in further discussions with Michigan state agent, very few follow up questions were asked regarding our responses to the questionnaire. As if the question on whether or not we owed Michigan Single Business Tax was a foregone conclusion and the questionnaire was a formal process having little

significance in determining whether or not we owed any tax. We subsequently determined agent(s) from the state were contacting dealers domiciled in the state posing as interested customers to inquire regarding how we delivered the product, do we have sales representatives in the state, how often they visited the dealer, do we assist in unloading product, and how was the warranty process handled. Based on the dealer's responses it was deemed by the state we had an obligation to register, pay tax and the burden was on us to disprove comments made by our dealer's. Regardless of whether or not the dealer could have made incorrect responses, didn't understand the basis of the question, or confused us with one of their other product lines.

Our experience with the State of New Jersey is nothing short of extortion. We received a phone call on October 6, 2004 from someone purporting to be an agent with the New Jersey Division of Taxation and agent indicated he was in possession of our truck with a load of boats destined for delivery in the state. Agent subsequently indicated the truck is to be impounded, along with the boats, unless we immediately remitted $27,500. Investigative agent claimed nexus arose because we deliver product into the state on trucks owned by Monterey, however, at the time the trucks were leased through a California entity. We also determined the $27,500 figure was determined based on a "field formula" having no basis or relation to property, payroll or sales. After refusing to remit any funds for tax based on a field formula, we engaged an attorney to intervene on our behalf with the state. On the afternoon of October 6th our attorney negotiated the release of the truck and boats. However, on October 7th we received a Warrant of Execution Jeopardy Assessment demanding payment for $176,000, again based on some unexplainable "field formula." In addition, the state placed a lien by levy on funds due to us from New Jersey dealers' finance company. Subsequently, on October 13th we provided

detailed sales information for the years 1998 through 2004 and were assessed income tax of $52,000 and $5,200 for the cost of collection.

On December 21st 2004 we filed a petition to protest and request for refund with the conference & appeals branch. On April 12th 2006, we received a letter notifying us our conference hearing was scheduled for July 6, 2006. Included in the notification letter, was a list of items the state wanted us to provide to them prior to the hearing. The first 6 (six) items on the list entailed questions regarding the warranty policy for Monterey and no follow up questions regarding use of or delivery of boats on Monterey owned or leased trucks. Appearing as if the reason for New Jersey having authority to impose tax, delivery of product on Monterey owned trucks, no longer applied.

On October 3rd, 2006 we met with the Conference and Appeals branch to resolve the issue and clarify our responsibility with the state. Subsequent to that hearing we submitted a proposed resolution and to date no response has been received.

Lastly, our experience with Washington State included receipt of Washington Business Registration application and the state's position regarding warranty repairs and delivery via common carrier. Consistent with other states, Washington contacted independent dealer's in the state, posing as interested customers, and inquiring about the relationship of dealer with the manufacturer.

Due to small amount of sales in Washington we determined litigation was not a cost effective approach and remitted the tax, interest and penalties for 1999 through 2006 of $44,597. We continue to prepare and remit quarterly combined excise tax returns.

Our sales are down 13% year to date, full time employee count is down approximately 15%. Whether we can attribute the decrease to competitive pricing pressure or to other factors is difficult to say. However, at the very least we are

experiencing an unprecedented amount of pricing pressure in the boating industry requiring us to offer more and higher incentives. In the short term, we consider rebates and incentives an investment in establishing or increasing our market share. However, in the long term, the continued pressure on profitability has consequences, as you know, profound layoffs, decreased competition and possibly bankruptcy.

Monterey is the largest employer in the surrounding geographic area and the loss of jobs has a profound and rippling effect through the local economy. In order to establish consistent application of "doing business in a state," we need clear guidance through legislation.

Thank you,

Mark Ducharme

CFO

Monterey Boats

Ms. SÁNCHEZ. Thank you, Mr. Ducharme. I appreciate your testimony.

At this time, I will invite Mr. Johnson to give his oral testimony.

TESTIMONY OF R. BRUCE JOHNSON, COMMISSIONER, UTAH STATE TAX COMMISSION, SALT LAKE CITY, UT

Mr. JOHNSON. Thank you, Madam Chairwoman and Members of the Subcommittee.

I appreciate this opportunity to testify today.

I am Bruce Johnson, one of the commissioners of the Utah State Tax Commission.

I am here today testifying on behalf of the Federation of Tax Administrators and the Multi-State Tax Commission.

The FTA is an association of tax administrative agencies in all of the 50 States, the District of Columbia, Puerto Rico, and New York City.

The Multi-State Tax Commission is an organization of State governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multi-state and multi-national enterprises.

FTA and MTC both strongly oppose this legislation because the bill would result in significant revenue losses for the States. It would reverse years of judicial precidents under the basis for State taxation. And it would create tax planning opportunities for multi-state, large multi-state enterprises that would not be available to locally-owned small businesses.

In addition, we believe that there has been a failure to show an adequate need for this legislation.

The Congressional Budget Office estimated in 2005 that predecessors of the current bill would result in a $3 billion annual revenue loss, the largest unfunded mandate CBO had ever measured.

The National Governors' Association estimated an annual range of lost State revenues from $4.7 billion to $8 billion with a single best estimate of $6.6 billion.

We are currently in the process of updating those estimates, but it appears that the losses under this bill will be the same order of magnitude as they were under the prior bill.

The bill, as proposed, has two major components. First, it expands Public Law 86-272.

Public Law 86-272 already allows a corporation to have a full-time sales force in a State, full-time, driving company cars on State roads. As long as the activities of that sales force will limited to the solicitation of sales of tangible personal property and ancillary activities that company is exempt from corporate income tax.

That is unfortunate enough. That is simply bad policy.

But this bill—at least 86-272—is limited to corporate income taxes and sales of tangible personal property.

This bill would allow the same full-time sales force to be in a State soliciting sales of services and sales of intangible property. It would also allow those representatives to be in the State full time if they were purchasing agents purchasing sales or services on behalf of a corporation.

So not only do you have sales people, you have got purchasing agents now who can be in a State full time and be exempt from taxation.

Second, the bill would prohibit States from taxing a myriad of other activities if the corporation did not have a bricks and mortar facility in the State or employees in the State for more than 15 days.

But there is also an exception if they were there for transient or limited purposes where you can be in the State for more than 15 days if you are there for a limited purpose.

What is a Federal court going to do with a limited purpose? If I am an architect from out of State and I am in a State for a year supervising the construction of a shopping center, am I there for a limited purpose? Arguably, I am.

If that is my only presence in the State, is it transient? Arguably, it is.

This bill will not provide the kind of certainty that its proponents hope for.

It also provides all sorts of tax planning. Let me give you two examples.

A Utah bank has 10,000 Visa card holders. It pays income tax on the fees it receives from merchants and on the interest.

An out-of-state bank blankets Utah with solicitation for card holders, signs up the same 10,000 people to conduct the same transactions with Utah retailers, pays the same interest, that bank is exempt from Utah income tax. They are competing head to head. That doesn't make any sense in today's economy.

Second, two toy stores, both in South Carolina, next to each other. They both have the same sales. They both have the same profit margin. One has an intangible holding company and pays 3 percent of its gross sales as a royalty to a Delaware holding company, obliterating its sales tax or its income tax obligation.

This is simply bad tax policy. It creates an unlevel playing field between interstate and local businesses, and we urge you to oppose this legislation.

Thank you.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF R. BRUCE JOHNSON

STATEMENT OF

R. BRUCE JOHNSON
COMMISSIONER, UTAH STATE TAX COMMISSION

BEFORE THE

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW
OF THE COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

ON

H.R. 5267
THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

JUNE 24, 2008

Madam Chairwoman, Ranking Member Cannon, and Members of the Subcommittee, thank you for the opportunity to address the Subcommittee concerning H.R. 5267, the Business Activity Tax Simplification Act (BATSA). I am Bruce Johnson, Commissioner of the Utah State Tax Commission. Today, I am testifying on behalf of the Federation of Tax Administrators (FTA) and the Multi State Tax Commission (MTC). FTA is an association of the tax administration agencies in each of the 50 states, the District of Columbia, Puerto Rico, and New York City. 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.

FTA and MTC strongly opposes H.R. 5267 because the bill would:

- Result in very significant revenue losses for the states at a time states can least afford to see their revenues shrink;
- Reverse years of judicial precedent that are the basis for state taxation; and
- Create tax-planning opportunities for large businesses to eliminate state taxation of revenues earned in a state, by substantially narrow states' authority to tax entities operating in the state.

In addition, the proponents of the bill have failed to demonstrate a need or a plausible purpose for the legislation.

What is the effect of BATSA on state revenues?

The Congressional Budget Office (CBO) estimated in 2005 that the predecessors of the current BATSA bill, which imposed fewer restrictions on states' taxing authority, would result in a $3 billion annual revenue loss, the largest unfunded mandate CBO has ever measured. In 2005 the National Governors Association estimated an annual range of lost state tax revenues from $4.7 billion to $8 billion, with a best single estimate of $6.6 billion.

The revenue loss estimates are currently being updated. The information available to date continues to indicate that the very substantial revenue losses estimated in 2005 will result if the current legislation is enacted into law.

Eight states have reported revenue loss estimates in the first year following the possible enactment of H.R. 5267. Due to the uncertainty of the actual revenue impact on their state, four of the responding states have provided estimates of the minimum impact and the maximum impact as well as their "best" estimate of the impact of HR 5267. The ranges of the annual revenue loss of the states are as follows:

Estimated Revenue Loss From H.R. 5267
Fiscal Year 2010

Responding States	Minimum Impact	Best Estimate	Maximum Impact
	(millions)		
California	$45.0	$45.0	$45.0
Idaho	20.0	20.0	20.0
Illinois	90.0	100.0	110.0
Kansas	43.3	43.3	43.3
Minnesota	60.0	66.0	73.0
New Jersey	366.4	366.4	366.4
New York	589.8	613.4	766.8
Oregon	65.8	163.4	263.4

In addition, the revenue loss over time appears to repeat the pattern of a rapid increase as businesses take advantage of the BATSA tax planning techniques. Two of these eight states, California and New Jersey, have been able to estimate the revenue loss through 2013.

Fiscal Year	California	New Jersey
	(millions)	
2011	$135.0	$459.5
2012	339.0	559.1
2013	614.0	665.7

How do states tax businesses now?

States levy various forms of business activity taxes today. The most common is the corporation net income tax imposed in 44 states and D.C. Other types of business activity taxes that would presumably be affected by the bill include the Washington State Business and Occupation Tax, Ohio Commercial Activity Tax, Michigan Business Tax and Texas 'Margin Tax' (which are general business taxes levied on gross receipts [or a variant thereof] sourced to a state) as well as the New Hampshire Business Enterprise Tax (a value added tax.)[1]

Current law requires a state to establish that a business has a sufficient connection with the state before it may exercise its jurisdiction to impose a business activity tax. The state's tax must bear a relation to the level of activity of the business in the state.[2] The U.S. Supreme Court has held that a company meets the jurisdictional standard of sufficient contacts ("substantial nexus" in the words of the Court) if it is "doing business" in the state or otherwise engaged in "establishing and maintaining a market" in the state. It has also held that the tax is fairly related to the level of activity in the state if the income of the company is divided among states in which the business is operating in a fashion that reasonably reflects the taxpayer's activity in the state.

Once jurisdiction to tax is established, state corporate income taxes generally operate as follows. The state tax base is federal taxable income of the taxpayer in all states, plus and minus certain modifications (e.g., to exclude certain income that states may not constitutionally tax.) The income from activities in all states is then "apportioned" or divided among the states in which the company operates according to a formula that usually compares the corporation's payroll, property and sales (the factors) in the state compared to the company's payroll, property and sales "everywhere" or in all states.[3] Once the income attributable to an individual state is determined, the state's rates, credits and other adjustments are applied to determine the final tax owed.

What is being proposed?

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[1] BATSA defines a business activity tax as (1) a "a net income tax" defined as the term is used in P.L. 86-272, as well as "Other Business Activity Tax – (A) IN GENERAL – The term 'other business activity tax means any tax in the nature of a net income tax or tax measured by the amount of, or economic results of, business or related activity conducted in a state." Other taxes that would fall under the bill include the franchise/capital stock taxes levied in a number of states, the Delaware gross receipts tax, and certain other "doing business" taxes. These are of lesser importance from a revenue standpoint than the corporate income tax and other taxes enumerated above.

[2] See *Complete Auto Transit v. Brady* 430 U.S. 274 (1977). This case sets out two other tests for state taxes that do not come into play in the context of BATSA.

[3] Gross receipts taxes are subject to the same "substantial nexus" requirement as corporate income taxes, but they are not apportioned according to a formula. Instead, the various transactions to which the tax is applied are "sourced" to a single jurisdiction according to certain rules, and that determines which state has the right to tax the transaction, provided the jurisdictional standard is met. Gross receipts and other non-net income taxes are specifically not subject to P.L. 86-272 today.

BATSA has two major components: (1) It significantly narrows state taxing jurisdiction by requiring that an entity must have one or more of certain specifically enumerated types of physical presence in a state before that state could impose a business activity tax on the entity[4]; and (2) It expands the reach and coverage of Public Law 86-272, a 1959 law intended to provide temporary restrictions on the ability of states to levy net income taxes on certain multistate businesses. The combination of the two changes would establish a new framework in federal law that reverses current law. The new `Federal framework would allow large, multi-state businesses to engage in tax structuring and planning, that would enable them to avoid a significant part, if not all, of their state tax liabilities.

How does BATSA affect current law regarding the states' jurisdiction to tax businesses operating in the state?

BATSA is often described "codifying the current physical presence standard" for state jurisdiction to tax. Despite the many statements to the contrary, the physical presence test has never been the standard for imposing business activity taxes on corporations. The U.S. Supreme Court has never held that a physical presence is required to meet "substantial nexus" requirement the Court requires for the imposition of a state business activity tax. In the only case, the 1992 *Quill* case, where the Supreme Court has used a physical presence test, the Court did so in order to be able to require the collection of state sales taxes from in-state customers by out-of-state sellers. In *Quill* the Court specifically said it was not establishing such a requirement for other taxes. The BATSA legislation would for the first time prohibit a state from imposing a business activity tax on a company doing business in the state unless the company had specifically enumerated types of physical presence in the state.

Further, since *Quill*, the vast majority of state appellate courts that have addressed the question of whether the physical-presence requirement of *Quill* applies outside of the context of sales and use taxes have ruled that it does not. Those court decisions include: *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 124 S.Ct. 961 (2003); *A&F Trademark, et al. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *review denied* (N.C., 2005), *cert. denied*, 126 S.Ct. 353 (2005); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 122 S.Ct. 1915 (2002); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), *cert. quashed* (N.M., 12/29/05); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07) ; *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), *appeal denied*, 731 N.E.2d 762 (Ill.

[4] It accomplishes this by first establishing a physical presence requirement and then expanding the list of activities "protected" (i.e., to be disregarded in determining whether a company has a substantial nexus with the state) under P.L. 86-272.

2000); *Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07). These decisions indicate that the vast weight of the case law, from both the U.S. Supreme Court and state appellate courts, indicates that the physical-presence requirement of *Quill* does not apply outside of the context of sales and use taxes.[5]

BATSA would also negate U.S. Supreme Court decisions that found a company meets the "substantial nexus" requirement by virtue of activities performed on its behalf by others. Specifically, the Court's 1987 decision in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue* would be reversed. In *Tyler Pipe*, the Supreme Court upheld the imposition of Washington's business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor, to establish and maintain a market in the state. BATSA provides that using the services of a representative to establish or maintain a market in a state would constitute a sufficient physical presence only if such representative were an "agent" of the entity and only "if such agent does not perform business services in the State for any other person...."

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[5] A few states' appellate courts have gone the other way: *Gillette Co. v. Dept. of Treasury*, 497 N.W.2d 595 (Mich. Ct. App. 1993) (ruling that P.L. 86-272 did not apply to the single business tax, but rather, the proper test was that of *Quill*); *Rylander, et al. v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000), *review denied* (Tex., 2001); *Acme Royalty Co. and Brick Investment Co. v. Director of Revenue*, and *Gore Enterprise Holdings, Inc. v. Director of Revenue*, 96 S.W.3d 72 (Mo. 2002); and *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal denied* (Tenn. 2000), *cert. denied*, 121 S.Ct. 305 (U.S. 2000). The latter two matters, however, each had a peculiar twist with regard to the nexus issue. In *Acme Royalty Co.* and *Gore Enterprise Holdings*, the Missouri Administrative Hearing Commission had determined that the physical-presence requirement of *Quill* did not apply in an income tax case, and ruled that the income of entities holding trademarks licensed for use in Missouri was subject to the state's income tax. The state Supreme Court then reversed those decisions with an opinion that did not use the word "nexus" or mention any constitutional issue, instead deciding the case on the basis of the state statute. And, in Tennessee, the Court of Appeals later reversed a decision that was based on the *J.C. Penney* decision's determination regarding *Quill*, and indicated that it did not rule in *J.C. Penney* that nexus could only be supplied by the physical presence of the taxpayer, stating, "Perhaps it would have been more accurate to say that the Supreme Court had rejected state taxes on interstate commerce where no activities had been carried on in the taxing state *on the taxpayer's behalf*." The court stated, "We know that a substantial nexus may be established by activities carried on within the state by affiliates and independent contractors. [Citing *Tyler Pipe Industries v. Washington*, 107 S.Ct. 281 (1987), and *Scripto v. Carson*, 80 S.Ct. 619 (1960)]. In fact, the only situation where we know that a substantial nexus does not exist is where the only contact with the state is by the Internet, mail and common carriers [*Quill, Bellas Hess*]. Where, on the other hand, activities are "being conducted in the taxing state that substantially contribute to the taxpayer's ability to maintain operations in the taxing state,' a substantial nexus does exist." *America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV (Tenn. Ct. App. 2002).

BATSA effectively knocks the legs out from under *Tyler Pipe* by allowing a company to avoid taxation in a state simply by using someone else to do its work in the state, as long as that contractor performs services for at least one other entity. The contractor may, in fact, be a wholly owned subsidiary of the taxpayer, so long as it performs work for someone else.

Finally, the bill expands the reach of Public Law 86-272 – which now prohibits states from imposing a net income tax on an entity whose only contact with the state consists of the solicitation of sales of tangible personal property – to include all business activity taxes (gross receipts, value added, franchise, etc.,) and to broaden the scope of protected activities to include all sales, including sales of other than tangible personal property, such as intangible property and services. It also extends the list of activities protected under P.L. 86-272 to include the "coverage of events or other gathering of information" in the state if the information is used or disseminated from a point outside the state and activities directly related to the actual or potential purchase of goods and services in the state, if the purchase is approved outside the state.

Creating a heretofore non-existent physical presence standard and expanding the reach of P.L. 86-272 represent a substantial narrowing of state jurisdiction to tax entities operating in the state.

How will BATSA create tax planning opportunities for large businesses?

There are several features of BATSA that will be used by multistate entities to structure and plan their operations and transactions in a fashion that allows them to avoid substantial tax liabilities. They include requiring certain types of physical presence to establish jurisdiction to tax, prohibiting consideration of the activities of contractors in determining whether an entity is subject to tax, and expanding the scope of activities protected under P.L. 86-272. These provisions have particularly insidious effects when coupled with certain existing state laws such as single sales factor apportionment which distributes income to the state based only on the percentage of sales in that state compared to the company's sales in all states.[6]

Together, these provisions provide a road map that a multi-state company can use to structure its business operations so as to avoid any state business activity tax liability. That is, to the extent that a company can insure that its activities within a state are performed by someone else, do not step over the physical presence boundaries of BATSA or exceed the scope of protected activities under the expanded P.L. 86-272, a company can eliminate or reduce its tax liability in that state. A company can avoid tax in a single

[6] Traditionally, states assigned equal weight to each of the three apportionment factors – property, payroll and sales. Recently, states have deviated from the traditional three-factor formula to provide greater weight to the sales factor. At the present time, 11 states employ (or allow on an optional basis) a single factor (sales) formula (i.e., sales are apportioned among the states based solely on the proportion of a company's sales in the state), 26 states employ a formula that has three factors but super-weight the sales factor, and 9 states use the traditional equally-weighted three factor formula.

sales factor state by locating its physical assets in that state, but making sales into the state through another company.

By establishing the tax planning opportunities so clearly in Federal law, BATSA may effectively require a company to begin engaging in certain planning activities that it currently considers too risky or inappropriate out of a fiduciary duty to shareholders. Here are several specific examples of avoidance opportunities that BATSA condones.

Examples of the manner in which this can be accomplished are presented below.

What are examples of BATSA tax planning techniques large companies will use?

No Physical Presence Business Operations. Larger businesses in certain industries are particularly well suited to conducting business in high volumes in a state without having a physical presence of any sort there. As a result, they will be able to avoid state taxation if BATSA is enacted. Every service a bank offers – including savings accounts, loans, and investment services – can be offered without any physical presence in a state. Under BATSA, large banks will be able to add to their economies of scale advantages of local banks by operating tax free in many states even if they do hundreds of millions of dollars of business in a state. In fact, it is precisely this type of financial services operation (credit card issuance and servicing) that was carried on without a physical presence in the state and that was found to constitute a sufficient nexus in the *MBNA* case in West Virginia.[7] BATSA would overturn that case and similar statutes in several other states that apply an economic presence test to financial institutions.

Intangible Holding Company. A strategy used by a number of companies is to create a holding company that is the wholly owned subsidiary of a major retailer to own the intangibles (patents, trademarks, service marks, etc.) of the retailer. Those intangibles are then licensed to the retail operations of the company, and each retail store is then required to pay a license fee (often just about equivalent to the profit earned by the store) to the intangible holding company that is customarily located in a state (e.g., Delaware or Nevada) that does not tax income from the licensing of intangibles. The retail stores take a deduction as a current expense for the licensing fee paid to the holding company. This transaction has the effect of shifting income from the state where it is earned (i.e., where the stores are) to a state where the income is not taxable – even though the holding company and the retail stores are all part of one corporate group and the holding company commonly has little in the way of actual operations.

Currently, this is considered risky tax planning. Many companies do not engage in such arrangements because a number of states have had assessments against such

[7] See *Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07).

holding companies affirmed by the courts."[8] If BATSA becomes law, a state would be prohibited from taxing the holding company to which the income was shifted because the holding company would not have any of the specifically enumerated types of physical presence in the state. BATSA would prevent states where the retail stores are located from taxing the holding company even though the income came from the retail operations in that state. The physical presence rule in BATSA would likely require many more companies to use an intangible holding company structure to minimize their taxes because of the fiduciary duty they owe to their shareholders.

In-state operations can further reduce their state tax liabilities by borrowing the funds paid to the holding company. The interest on the loans will be deductible from income earned in the state. The loans to in-state companies can be made out of payments for the use of the holding company's intangible assets made by the same the in-state subsidiaries. Loans with deductible interest payments also could be made to other subsidiaries of the parent corporation. This in effect is a double benefit of tax planning under BATSA.

Using a Contractor. Another simple tax avoidance strategy under a BATSA regime involves the use of contractors in a state to perform activities necessary for a seller to maintain a market in the state. Assume, for example, an out-of-state retailer of computers or other electronic devices markets its products into a state via the Internet, sales people operating within the confines of P.L. 86-272, and other direct sales methods. The sale of computers and electronic devices includes warranty contracts. The out-of-state retailer contracts with an independent contractor to provide the warranty service to its customers. The independent contractor provides similar services to other out-of-state retailers, all of which could be affiliates of one another. Under BATSA, the out-of-state retailer would not be subject to a business activity tax in the state into which it sold the computer because the activities of the contractor (even though essential to being able to sell its computers) could not be attributed to the seller – even if it used in-state sales personnel as long as they stayed within the confines of P.L. 86-272.

What is wrong with the justifications of BATSA by its proponents?

Assertion: States use abusive tactics in collecting taxes by seizing goods in transit and claiming that transporting goods through a state is doing business in a state.

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[8] Those cases include, but are not limited to: *Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07) (franchise and corporate net income taxes): *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993) (income tax); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003), cert. denied (U.S., 2003) (income tax); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), cert. denied, 122 S.Ct. 1915 (2002) (business and occupation tax); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), appeal pending (income tax); and, *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), appeal denied, 731 N.E.2d 762 (Ill. 2000) (replacement income tax).

Response: The most common complaint we have encountered comes from large corporations that are not in compliance with state laws. These large multi state corporations fail to pay business activity taxes. When their property is identified in a state, the state institutes a jeopardy assessment. The object of the jeopardy assessment can be merchandise in transit. The property is seized to satisfy a pre existing tax liability. It is not the transit of the merchandise in a state that creates the tax liability or the jurisdiction to subject the company to a state's business activity tax. Rather the merchandise is being seized to satisfy a tax liability that the taxpayer is not willing to pay or address for conducting business in the state in a manner that satisfies the substantial nexus standard for taxation required by the U.S. Supreme Court.

State and Federal authorities use the jeopardy assessment procedure as a last recourse. States use a variety of means to generate voluntary compliance with their tax laws, such as tax amnestics and jeopardy assessment suspensions when industry groups cooperate to encourage voluntary compliance. It is only when there is no other option to collect a tax liability and the property is likely to leave the state that a jeopardy assessment is used. The jeopardy assessment also is subject to the appeal rights that the taxpayer has.

Assertion: The bill is necessary to establish a "bright line" so that a company will know when it is subject to tax.

Response: The physical presence requirements in the bill are far from a "bright line." BATSA does not require simply that a company have a physical presence in the state in order to be subject to the state's tax jurisdiction. For example, one company could have 100 employees in a state for 14 days (1,400 person-days) and not have nexus, while another company could have 1 person in a state for 16 days (16 person-days) and have nexus. In addition, a company must have certain types of physical presence that are not protected by the expanded P.L. 86-272 and that do not fall within the *de minimis* exceptions of BATSA or the "limited or transient" exception in BATSA. The various limitations and carve-outs from physical presence will create confusion, uncertainty and litigation as companies attempt to move up to the line of BATSA, but not cross over it. A simpler nexus or physical presence standard, and a repeal of P.L. 86-272 would be a bright line. BATSA is not a bright line.

Assertion: BATSA is designed to protect small businesses from being subject to tax in every state in which it might make a sale.

Response: The physical presence requirements of BATSA are not designed to assist small businesses. They are, instead, intended to provide opportunities for large companies to structure and plan to avoid state taxes. The U.S. Constitution and due process considerations require more than a single sale before a state could exercise its tax jurisdiction. States are willing to work with the business community to structure *de minimis* standards that will provide clarity for small businesses. BATSA does not provide an appropriate framework for such a standard.

Assertion: Companies with no physical presence in a state do not use services in the state and should not be subject to tax.

Response: The assertion that an out-of-state seller derives no benefits from a state in which it has no physical presence (and thus should not be subject to tax) is "indefensible." Two noted scholars in the field of state and local taxation responded to that argument as follows:

> This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible. A profitable corporation clearly enjoys both types of benefits. It is true that in-state corporations may receive greater benefits than their out-of-state counterparts, for example, because they have physical assets that need fire and police protection. But that is a question of the magnitude of benefits and the tax that is appropriate to finance them -- something that is properly addressed by the choice of apportionment formula and the tax rate, not the type of yes/no question that is relevant for issues of nexus. The answer must clearly be a resounding yes to the question of whether the state has given anything for which it can ask in return.[9]

Assertion: Taxing entities that have only a physical presence in a state amounts to "taxation without representation."

Response: While "no taxation without representation" is a catchy slogan, the Supreme Court has long upheld the right of states to impose taxes on nonresidents (individuals and corporations) doing business in a state. Moreover, the companies supporting BATSA have found plenty of avenues for making their desires known to state elected and appointed officials. Most importantly, the issue here is one of equal taxation of in-state businesses and out-of-state businesses. If that is achieved, the in-state representatives will effectively represent the interests of out-of-state businesses.[10]

Conclusion

Thank you Madam Chairwoman for the opportunity to testify on the important subject of business activity tax nexus legislation. The current system of state taxation has developed over many years and we believe it is fundamentally sound. Legislation like H.R. 5267 turns the system upside down and would create massive revenue losses for the states. We urge you to reject the legislation.

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[9] Charles McLure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, February 26, 2004.

[10] For a more complete discussion, see McLure and Hellerstein, op. cit., p. 735.

Ms. SÁNCHEZ. Thank you for your testimony, Mr. Johnson.

At this time, I would invite Mr. Petricone to provide his oral testimony.

TESTIMONY OF MICHAEL PETRICONE, VICE PRESIDENT, TECHNOLOGY POLICY, CONSUMER ELECTRONICS ASSOCIATION, ARLINGTON, VA

Mr. PETRICONE. Good afternoon, Madam Chairwoman and Members of the Subcommittee.

The Consumer Electronics Association [Inaudible] to create jobs, drive the economy, and—I don't have to tell you in these tough economic times that [Inaudible].

There is one issue, however, that this Subcommittee can immediately address: The growing number of States using economic nexus theories to unfairly tax companies that have no physical presence within the State.

No taxation without representation is America's first governing principle.

Having established our nation under that basis, our founders went further. They created a single national economy and imposed constitutional safeguards to ensure that States cannot act to impede interstate commerce.

Unfortunately, the system our founders put in place is now eroding.

The number of States with a statute or regulation establishing economic nexus without a physical presence has now grown to more than a dozen.

The problems caused by this growing patchwork of taxation are obvious and they fall disproportionately on our small business members.

As you know, small businesses run close to the bone. To [Inaudible] beneath reasonable taxation in a settled, predictable business climate, but increasingly, they face significant costs [Inaudible] their State tax liabilities.

They must meet multiple filing requirements, keep multiple records, and deal with multiple sets of regulators.

It is becoming difficult for them to make any reasonable estimate of their projected tax burden. You can imagine the challenges of long-term business planning in such an environment.

Of course, small firms also have fewer resources to challenge questionable assessments in far away States. As a practical matter, when faced with these levies, they have little choice but to bite the bullet and write the check.

As a technology association, we are especially concerned with the burdens the situation places on electronic commerce.

At the very moment, the Internet grants every business access to a national marketplace, a crazy quilt of local tax obligations, throws a roadblock across the electronic highway.

Businesses will avoid sales in the various States, and consumers, especially those in the remote areas, will be unable to go online and get the goods they need.

This situation will not resolve itself. In fact, left alone, it will get worse.

Out-of-state businesses present at the timing targets to legislators seeking to raise revenue. Naturally, States have every political incentive to exploit their tax burdens as aggressively as possible.

Meanwhile, States are making conflicting decisions and the Supreme Court has declined to address this issue. Specifically, the Supreme Court recently refused to hear two cases challenging the constitutionality of the economic nexus approach. Naturally, States see this as a green light to press forward with more economic nexus legislation.

Pursuant to your authority under the commerce clause, it is time for you to act. There is ample precedent here.

A few examples: You have moved to prevent multiple States taxes on electronic commerce. You have ensured that States cannot impose apply-over taxes on airlines.

And you have restricted taxation of mobile communication services to the State where the service is primarily used.

Specifically, we now urge you to support H.R. 5267, the Business Activity Tax Simplification Act of 2008. The bill provides that, pursuant to the commerce clause, a State may not impose business activity taxes on businesses that have no physical presence in the State.

And the physical presence rule clearly clarifies the State taxation landscape. It is easy to understand. It is easy to enforce. Its bright-line standard ensures that small businesses know with certainty when and where they will be taxed.

For a business owner, this means fewer resources spent on tax compliance and litigation and more resources invested in building their business.

Such an approach would also ensure compliance with our international treaty obligations. In every tax treaty to which the U.S. is a party, the universal climate for imposing income taxes on nonresidents is physical presence in the taxing jurisdiction.

This is a fair and reasonable solution. Contrary to opponents' claims, it will not limit a State's ability to tax shelters or allow businesses to restructure their activities to avoid paying legitimate taxes. That is not the intention here. Our members are good corporate citizens.

We do not object to paying our fair share of taxes. We simply believe that States that provide meaningful benefits to the business, like water, roads, fire, police protection, should properly receive the tax revenue rather than a distant State that provides no benefits.

Members of the Committee, the constitution is clear. The right to regulate beyond individual States' borders lies, not with the States but with Congress. A bright-line physical presence rule eliminates ambiguity, stimulates investment, and promotes interstate commerce. It is good for large and small businesses, and it is good for the economy.

We urge Congress to support H.R. 5267, the Business Activity Tax Simplification Act of 2008.

I commend you for holding this hearing, and I look forward to answering your questions.

[The prepared statement of Mr. Petricone follows:]

PREPARED STATEMENT OF MICHAEL PETRICONE

Before the
House Judiciary Subcommittee on Commercial and Administrative Law

Business Activity Tax Simplification Act of 2008

June 24, 2008

Written Statement of Michael Petricone
Senior Vice President, Government Affairs
Consumer Electronics Association

Chairwoman Sánchez, Ranking Member Cannon and Members of the Subcommittee: on behalf of the Consumer Electronics Association (CEA), thank you for the opportunity to appear before your Subcommittee today to discuss the business activity tax nexus problem and the critical impact it is having on businesses across the country.

CEA is the principal U.S. trade association representing the $161 billion consumer electronics industry. We are also the owners and producers of America's largest annual event, the International CES, held every January in Las Vegas Nevada.

Our more than 2,200 members are involved in the design, development, manufacturing, distribution and integration of audio, video, in-vehicle electronics, wireless and landline communication, information technology, home networking, multimedia and accessory products, as well as related services that are sold through consumer channels.

While CEA's members include virtually all of America's top technology companies as well as many of the leading retailers, more than half of our members are small businesses.

American businesses today face a host of new challenges from skyrocketing energy costs to the uncertain availability of investment capital. Many of these factors arise from complex market forces which are not amenable to immediate resolution. There is one issue, however, that this Subcommittee can address and resolve: the increasing number of states using dubious

"economic nexus" theories to levy income and franchise taxes against companies that have customers but no physical presence in the taxing state. These punitive taxes harm businesses – especially small businesses, and violate the U.S. constitution by unduly burdening the free flow of interstate commerce.

The problem is bad and getting worse. The number of states with a statute or regulation establishing "economic nexus" without a physical presence has grown to more than a dozen known states. Additionally, at least eight states, including Louisiana, Maryland, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina and West Virginia have made a similar decision at the administrative or judicial levels.

The problems engendered by this growing "crazy quilt" of state levies are obvious. American businesses, large and small are faced with burgeoning compliance costs. They face an unclear business environment with no way of estimating where and when they will be taxed. Business expansion is chilled, especially when it comes to electronic commerce which inherently crosses state borders. And companies face the risk of duplicative taxation, as they also pay legitimate taxes from the states in which they are domiciled.

While tax advocates claim that requiring a physical presence for the purpose of imposing a business activity tax would cost local and state governments billions of dollars annually, a 2006 study by Ernst and Young demonstrated that the aggregate multi-state revenue loss from all state and local taxes paid by businesses in 2005 would be less than one-tenth of one percent.[1]

Earlier this year, the House Small Business Committee examined the impact of the business activity tax on small businesses. Using the Ernst and Young data as a base, Dr. Peter Johnson, Vice President for Research Strategy and Platforms and Senior Economist of the Direct

[1] Ernst & Young, *Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections*, pg. 3 (July 25, 2006).

Marketing Association testified that through a clear physical presence test established by BATSA, the direct marketing industry could produce increased economic activity and add new jobs to the economy.[2] Such benefits could easily extend beyond direct marketing to those in a host of other industries, including consumer electronics.

Small businesses disproportionately bear the burden of these levies. They operate close to the margin, and their success requires fair and consistent regulatory treatment and a settled business environment. They are ill equipped to comply with multiple demands from multiple taxing entities, and lack the resources to challenge ill-founded levies.

Let me give you some examples from CEA's membership. Atlantic Technology is a small business based in Norwood, Massachusetts. A true model of American ingenuity, Atlantic Technology was founded in 1989 by Peter Tribeman and produces a variety of home entertainment products, including high-performance multi-channel speaker systems and state-of-the-art home theater electronics components.

Although the company has no physical presence and owns no inventory in the state of Washington, Washington's Department of Revenue has continually taxed Atlantic Technology because of their use of independent sales representatives. After the state described Atlantic Technology as a "tax delinquent" to one of its Washington state dealers, the Department of Revenue went a step further, suggesting that they would likely seize Atlantic Technology inventory as payment for taxes that the manufacturer owed the state. The dealer, who was unaware of this situation, was frightened by the prospect of losing their inventory to the state. Rather than wage an expensive legal battle, Atlantic Technology had no other choice, but to pay the taxes that they were alleged to owe.

[2] Testimony of Dr. Peter A. Johnson, Direct Marketing Association before the House Small Business Committee (Feb. 14, 2008).

Atlantic Technology has also faced additional tax levies by states such as Pennsylvania and Florida. Fighting this barrage of state taxes will require the use of scarce resources that should be going toward building the business.

Mitek, a family-owned and operated business based in Phoenix, Arizona, is facing a similar fight. Mitek produces well-known mobile audio brands such as MTX Audio and StreetWire, and provides good manufacturing jobs in the United States. Mitek has been hit with business activity taxes in several states, including California, Washington and Michigan, strictly based on the use of nonexclusive independent representatives.

It is time for Congress to step in and assume its constitutional responsibility to ensure that commerce is not harmed by unfair taxation. The Business Activity Tax Simplification Act of 2008, H.R. 5267 would provide the much needed relief to American businesses. We applaud the leadership of Representatives Rick Boucher (D-VA) and Bob Goodlatte (R-VA) in introducing this important legislation. H.R. 5267 will provide clarity by providing a bright line definition of physical presence. Most importantly, it provides relief to business by clearly preempting states from taxing corporations with no physical presence.

Our members are good corporate citizens, and we are not asking for relief from legitimate taxation. We are asking to restore a simple principle: a tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer. H.R. 5267 provides that only businesses receiving state and local benefits derived from such taxation like education, transportation, fire and police, should be subject to such taxes. Furthermore, the legislation will not impact states' ability to collect income or other legitimate taxes from its residents.

Congress has historically acted to invoke its Commerce Clause authority in similar situations. For example, Congress enacted the Federal Aviation Act to prohibit states from

imposing "flyover taxes," ensuring that aircrafts were only taxed by states where they take off and land. Recently, Congress enacted legislation to prohibit taxing Internet access and prohibit multiple or discriminatory taxes on electronic commerce. We urge Congress to act again to provide relief and greater clarity for all businesses, both large and small.

Therefore, I respectfully urge you to say no to taxation without representation and support the Business Activity Tax Simplification Act of 2008 (BATSA).

Ms. SÁNCHEZ. Thank you, Mr. Petricone.

At this time, I would like invite Mr. Quam to give his testimony.

TESTIMONY OF DAVID C. QUAM, DIRECTOR, OFFICE OF FEDERAL RELATIONS, NATIONAL GOVERNORS ASSOCIATION, WASHINGTON, DC

Mr. QUAM. Chairwoman Sánchez, Mr. Jordan, Members of the Subcommittee, it is a privilege to go back here before you again on behalf of the National Governors' Association, this time, expressing governors' strong opposition to H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

It is not often that governors can come together on a consensus basis behind a policy and then State that policy clearly. It just so happens that in this particular area, we have a very precise process statement from the governors.

"The nation's governors oppose any further legislative restriction on the ability of States to determine their own policy on business activity or corporate profits taxes. This is an issue of State sovereignty. The U.S. Constitution adequately protects the interests of both States and business."

"H.R. 5267, like its predecessors that we have discussed before, represents an unwarranted Federal intrusion into State affairs that would allow companies to avoid and evade State business activity taxes, increase the tax burden on small businesses and individuals, alter established constitutional standards for State taxation, and at the end of the day, cost States billions of dollars."

Rather than going through my written testimony, I wanted to focus on something because I think the witnesses covered it. There is a distinct question of philosophy here. Everyone talks about—and Congressman Goodlatte and Boucher, who I respect a lot—talked about modernizing a 49-year-old law.

The question is should we be modernizing the 49-year-old law. That is a difference economy and a different time.

It was a law put in place when business could only be done by a handshake, by traveling into a State. We are in an Internet-based economy, and we have experienced several debates with this Committee regarding what an Internet-based and communications-based economy means.

In today's economy, you can do business in another State without ever setting foot there. From a State's perspective, that means that out-of-state companies can come in, compete with your mom-and-pop stores and compete with your State businesses but not share the tax burden of the roads, the education, which I would argue that every company who is doing business in the State benefits from the services that are provided by that State.

I think, philosophically, States have come together with regard to simplification of big sales taxes. The Streamlined Sales Tax and Use Agreement is an example where States have come together to address the complex issue and try to solve a national problem in working with business.

At the end of the day, we are trying to mostly form a physical presence standard for sales taxes, which is what *Quill* said, into more of an economic presence standard where remote vendors can collect and be asked to collect those sales taxes.

To comment on the business activity side, say, we are going to reverse where we current stand and move backwards 49 years, does not make a lot of sense from a tax policy standpoint.

And certainly, when you are talking about congressional interference with State tax systems, Congress has to be very, very careful about when it crosses that line.

I would also like to say that this is a bottom-line issue. If I was representing a company right now, I also would be on this bill. I would support it because it is a $6 billion tax break for business. It is $6 billion that will go to almost any business who is not physically present.

However, it is also a $6 billion tax break that can go to companies who are physically present.

Under this bill, you can do the type of tax planning where you can have two toy stores next to each other; one who has the means to hire the tax counselors to actually exploit the loopholes in this bill. And all of a sudden, you have the same stores physically present in the State, one paying business activity tax and one not. That does not seem to be a good standard for Congress to be setting for a modern economy.

Lastly, there is a lot of talk about States entering into discussions.

I would agree that clarifying the laws, making it clear, moving forward, are discussions worth having, but they must be balanced with State interest of sovereignty and the revenue interest of States.

NGA is repeatedly on this issue over the past years, and I think Mr. Delahunt made this point at the last hearing. Please get together and have a discussion of how we can move forward.

Unfortunately, in that time, my phone rang once. And that call was to tell me that this bill was being dropped.

The governors would welcome a discussion, but I think we have to talk about what is the question that has to be—what is the question and what is the problem, and then what can we do in a balanced fashion that makes sense, respecting State sovereignty and the revenue concerns.

Thank you, Chairwoman.

[The prepared statement of Mr. Quam follows:]

PREPARED STATEMENT OF DAVID C. QUAM

Chairwoman Sanchez, Ranking Member Cannon and members of the Subcommittee, I am pleased to be here on behalf of the National Governors Association (NGA) to communicate governors' strong opposition to H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

Governors oppose H.R. 5267:

Governors' long-standing policy regarding federal interference with state business activity taxes is clear and unambiguous. NGA Policy reads:

> **"The nation's governors oppose any further legislative restriction on the ability of states to determine their own policy on business activity or corporate profits taxes. This is an issue of state sovereignty. The U.S. Constitution adequately protects the interests of both states and business." (NGA Policy Position, EC-9)**

H.R. 5267, the "Business Activity Tax Simplification Act of 2008," like its predecessors in other Congresses, represents an unwarranted federal intrusion into state affairs that would allow companies to avoid and evade state business activity taxes (BAT); increase the tax burden on small businesses and individuals; alter estab-

lished constitutional standards for state taxation; and cost states billions in existing revenue. While governors welcome the opportunity to discuss issues related to business activity taxes, they urge Congress to oppose measures such as H.R. 5267 that would assist large corporations to the detriment of other taxpayers and states.

1H.R. 5267 violates core principles of federalism:

Governors oppose H.R. 5267 because it represents an unnecessary intrusion into the states' authority to govern. U.S. courts have long recognized the authority of a state to structure its own tax system as a core element of state sovereignty. H.R. 5267 would interfere with this basic principle by altering the constitutional standard that governs when states may tax companies conducting business within their borders. Specifically, the bill would mandate the use of a physical presence standard for determining whether an entity can be taxed. This differs from economic presence, such as the "doing business" or "earning income" standards used by most states. As discussed below, this change would shrink state tax bases by relieving out-of-state businesses of BAT liability while allowing larger in-state companies to circumvent tax laws by legalizing questionable tax avoidance schemes. These outcomes would effectively constitute a federal corporate tax cut using state tax dollars—a decision that, fundamentally, should be left to state elected officials.

1H.R. 5267 would encourage tax evasion and avoidance:

H.R. 5267 promotes avoidance of state taxation. At a time when the federal government is closing loopholes in the federal tax code, H.R. 5267 would subvert state tax systems by creating opportunities for companies to structure corporate affiliates and transactions to avoid paying state taxes.

The bill's physical presence standard would significantly raise the threshold for business income taxation in most states and, according to a January 20, 2006 report by the Congressional Research Service (CRS) on similar legislation, lead to more "nowhere income." In fact, CRS noted that legislative exceptions to the supposed physical presence standard, including its massive expansion of P.L. 86–272 to services, "would . . . expand the opportunities for tax planning and thus tax avoidance and possible evasion."

If H.R. 5267 provides the opportunity for planning, corporations will use it to avoid taxation. For example, a recent Wall Street Journal article demonstrated the extent to which corporations already work to avoid state business taxation. ("Inside Wal-Mart's Bid to Slash State Taxes," *Wall Street Journal*, Oct. 23, 2007.) The article details the extensive tax avoidance strategies of Wal-Mart as it sought to reduce its state tax liability through a series of sophisticated strategies, some of which states later identified as abusive and illegal tax shelters. A common thread among the strategies was the formation of entities in jurisdictions that do not tax certain activity, followed by a shift of income to the entity to avoid taxation. If enacted, the physical presence nexus standard of H.R. 5267 would federally codify such tax practices and grant corporations with the means to restructure their businesses with a federal permission slip to aggressively avoid state taxation.

H.R. 5267 would harm locally-owned and small businesses:

H.R. 5267 would favor large, multi-state corporations to the detriment of small businesses and individual taxpayers. By raising the jurisdictional standard for taxation, H.R. 5267 would effectively limit a state's business activity tax base to in-state companies. Out-of-state vendors could therefore compete for customers against in-state businesses with the advantage of inequitable tax responsibilities.

At the same time, larger in-state companies with the size and means to hire professionals specializing in tax avoidance could minimize or eliminate their state business tax liability even though they are present in the state. This ability to be physically present yet avoid state taxation places a disproportionate tax burden on smaller, in-state businesses and individual taxpayers. Companies willing to compete for customers and earn revenue in a state should share the responsibility of paying for state services that benefit all businesses.

H.R. 5267 would alter established constitutional standards:

H.R. 5267 would alter the existing constitutional standard for taxation of business activity. The U.S. Supreme Court has never required a physical presence standard for imposing business activity taxes. In fact, since the time of this Subcommittee's last hearing on this topic in 2005, state courts, and through its denial of certiorari, the U.S. Supreme Court, have clearly established economic presence, not physical presence, as the appropriate standard for determining if a company has sufficient contacts to impose a business activity tax. (*A&F Trademark, Inc., et al. v. Tolson, 605 S.E. 2d 187 (N.C. Ct. App. 2004), review denied (N.C., 2005), cert denied, 126 S. Ct. 353 (2005); Kmart Properties, Inc. v. Taxation and Revenue Dept., No. 21,140*

(N.M. Ct. App. 2001), certx quashed (N.M. 12/29/05); Lanco, Inc. v. Director, Division of Taxation, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07)). H.R. 5267 would disrupt this well-established constitutional standard and call into question state business activity tax systems in every state.

H.R. 5267 would undermine state revenues:

H.R. 5267 represents a huge unfunded mandate that will result in the loss of billions of state dollars. A survey released by the National Governors Association found that a substantially similar House bill, H.R. 1956, would cost states more than $6.6 billion annually. ("Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, On States," National Governors Association, September 26, 2005.) Preliminary cost estimates for H.R. 5267 yield similar results, with first-year loss estimates ranging from $20 million in a state like Idaho to over $366 million for New Jersey. State losses also will grow as companies restructure to take advantage of H.R. 5267's loopholes. California estimates that if enacted, H.R. 5267 would cost the state $135 million in 2011 then grow to more than $614 million just two years later.

This shift in revenue, while beneficial to business, is particularly harmful to states because unlike the federal government, states are required to balance their budgets. Consequently, when federal action causes states to lose revenues, states must act to replace lost funds by either increasing taxes or cutting programs. The economic effects of such actions are pro-cyclical in that they make economic downturns worse. NGA already predicts that 21 states are likely to face $34 billion in budget shortfalls for fiscal year 2009. Federal legislation that would reduce corporate state taxes by $6 billion annually would only further exacerbate the pro-cyclical pressures on states and thereby prolong the economic downturn and delay recovery.

Conclusion:

States have demonstrated that they are willing to address state tax issues on a national basis. Through projects like the Streamlined Sales and Use Tax Agreement, states have come together with the business community to fashion workable solutions that address both private and public sector interests.

Unfortunately, in the context of business activity taxes, proponents of bills like H.R. 5267 have shown little willingness to work with states to either properly define the problem or discuss solutions that balance the goals of certainty and consistency with state authority and revenue requirements. As a result, NGA will continue to oppose legislation like H.R. 5267 and call upon Congress to reject legislation that interferes with state business activity tax systems.

Ms. SÁNCHEZ. Thank you, Mr. Quam.

We will now begin our round of questioning, and I will begin by recognizing myself first for 5 minutes of questions.

Mr. Johnson, businesses contend that it is understandable for them to pay taxes when they receive government benefits in return, such as police and fire protection.

How do you respond to supporters of a physical presence standard who contend that businesses receive no benefit from government under the economic presence standard?

Mr. JOHNSON. Well, I would respond in two ways, Madam Chair.

First, I would say that—take the example of the bank, the out-of-state bank.

It is using the same financial infrastructure that a State bank is using. It is using the courts to enforce its contractual obligations.

It is benefitting from the working force and exploiting the market in the State the same way that a local bank is.

It doesn't have to pay property taxes because it doesn't have property there, but it is certainly exploiting the market and the civilized society that is created there.

So I think that bank does benefit from the courts, the infrastructure provided by the State.

Secondly, look at the toy store example. You can have, under this bill, you can have an intangible holding company that essentially sucks the profit out of a bricks and mortar company and it won't have to pay any tax.

Under 86-262, you can have those salesmen driving on State roads, being protected by the State police force, having company cars protected by the State police force and the fire department. They simply receive those benefits. They should pay a fair share.

Ms. SÁNCHEZ. Thank you.

Mr. Quam, I know you have been before this Subcommittee many times, but with respect to this particular issue, do you agree that there is a problem here? That there is a lack of a clear and uniform standard that has made it difficult for businesses to meet their filing obligations and to sort of plan prospectively?

Mr. QUAM. There are certainly different standards. But as we have talked many times, federalism is difficult.

The sovereignty of States to establish their own revenue systems is a core of that sovereignty. And so that will engender certain complexities.

Ms. SÁNCHEZ. But you don't think that, perhaps, we might be able to benefit from a little uniformity or a little more clarity?

Mr. QUAM. There can be benefits to uniformity. I think they really have to be measured against State sovereignty interests.

Again, I think States may be willing to discuss, you know, what the particular problem is and see if there is a way to clarify. However, States still need the flexibility to control and manage their own State systems.

Differences will always remain. There are some things that can be done. Unfortunately, under this bill, what you are really doing is gutting the entire system to solve what I think may be a much more pointed problem.

Also, one thing that this bill does not do is establish a clear line. Physical presence sounds clear, but not when you incorporate all the exceptions that still remain in this bill.

They might not be line for line like they were in previous measures, but they are still contained in here with some of the exceptions.

So, unfortunately, we don't have a bright-line before us.

Ms. SÁNCHEZ. That is a point well-taken.

You indicate in your written statement that H.R. 5267 would increase the tax burden on small businesses and individuals, and I am interested in knowing why you believe that.

Mr. QUAM. The reason for that is, going back to my example of the two toy stores, the fact of the matter is, under physical presence standards, particularly the one in this bill, you can have a company that is physically presently that does not pay tax.

Your small business who does not have the fleet of accountants and does not have the tax attorneys to do some of the planning necessary to take advantage of the loopholes in this bill is going to pay full freight.

They are going to pay the State business activity tax, the property tax. They are going to pay their taxes as good corporate citizens.

The company next to them that may be a large conglomerate or corporation that has the ability to do that can do the tax planning to avoid that State taxation, and now you have two stores running the same business. One has a lower tax burden than the other, yet both are physically present.

That increases the burden on those who are there that can't do that tax planning because the tax burden still remains within that State.

Ms. SÁNCHEZ. Mr. Petricone, I know that you stated that your members are good corporate citizens and that the purpose of this bill is not to evade taxes and I want to believe you.

But I do also know that there are, occasionally, a few bad apples that will try to exploit certain advantages.

I wanted to ask you specifically, earlier this year the New York State Bar Association recommended that Congress establish a clear nexus standard for a States' imposition of a business activity tax.

And it suggested that the standard take into account economic presence rather than a pure physical presence test and include a reasonable de minimis threshold before imposing a tax on a business.

Do you like anything at all about the Bar Association's recommendation? Or are you totally opposed and wholeheartedly just a supporter of the physical presence standard?

Mr. PETRICONE. Well, Madam Chairwoman, there is many ways to get there. One thing that small businesses need that is very important to them is certainty.

They want to know how they are being taxed, where they are being taxed, and who they are being taxed by.

Again, you know, when you have minimal resources, the notion of complying with multiple taxing entities operating under multiple rules is—I mean, it may sound look a minimal thing, but it is extraordinarily burdensome to you and expensive.

Ms. SÁNCHEZ. Wouldn't a small business that was subject to de minimis standards have some certainty?

Mr. PETRICONE. Right? Well, the attraction of the physical presence rule for us is that that is far and away the simplest to understand and the simplest to administer.

While I realize that there are other ways to get there, and that is good and that should be discussed, for us, it is the simplicity of the physical presence standard that is very attractive.

Ms. SÁNCHEZ. You are a physical presence standard only guy?

Mr. PETRICONE. That is what we believe to be the best solution, yes.

Ms. SÁNCHEZ. Okay. Thank you.

My time has expired. At this time, I would recognize our acting Ranking Member, Mr. Jordan, for 5 minutes of questioning.

Mr. JORDAN. Thank you, Madam Chair.

Mr. Johnson, a couple of times, you have mentioned 86-272 is clear that a company can have a sales force in a State driving on roads—to use your language—and not be subject to tangible personal property tax in that jurisdiction.

You also said in your opening comments that you think businesses have failed to show that there is adequate need to update this 1959 law.

How do you square what you just said with the example that Mr. Ducharme gave with his experience in the State of New Jersey and them seizing his property and stopping the boats from being delivered?

How do you square those two?

Mr. JOHNSON. Well, I guess I would respond to Mr. Jordan first.

I would agree that there is a need for some clarity in this area.

The Multi-State Tax Commission has promulgated a factor presence formula that would provide that most businesses don't have to pay any income tax in a State unless they have either more than $500,000 worth of sales, more than $50,000 worth of property, or more than $50,000 worth of payroll in the State.

I think something like that should be adopted by the States uniformly. I think an important part of tax policy is certainty, and small businesses do need certainty.

So to the extent that that problem exists, and it does exist, I think the States should work collectively to solve it. We would rather have the businesses come to us as States and solve that rather than have it imposed at the congressional level.

Second, I would just say that New Jersey is not here. They provided a letter that describes their jeopardy assessment policy.

Jeopardy assessments are common in the States. They are also used by the Federal Government.

There is always, at the very least, a post-deprivation due process hearing that is required in case those powers are being exercised inappropriately.

You know, without——

Mr. JORDAN. Okay.

Mr. Ducharme, in your experience, you related the New Jersey story, are you seeing this more widespread? Are you seeing other States being aggressive?

I mean, give me some of your experiences.

Mr. DUCHARME. Our personal experience in New Jersey has definitely been the most aggressive.

The process that we have encountered with the other States that have contacted us has been a phone call questionnaire. Mind you, that really doesn't have any merit to whether or not they are going to assess tax on you, but it has been more of a formal phone call questionnaire return separation process as opposed to what we encountered in the State of New Jersey.

Mr. JORDAN. Sure.

Any time any department of taxation is calling you, you certainly take notice, I would think.

Mr. DUCHARME. Yes.

Mr. JORDAN. I understand how that is.

Maybe you and Mr. Petricone, give me your general thoughts on where you think it is headed. I mean, if we don't get some clarification, what—give me your thoughts of what you see in the not too distant future and how that impacts you.

And I know you have talked about that some. I will come back to you, Mr. Petricone.

Mr. PETRICONE. Right. Congressman Jordan, what worries me about this issue is, left to its own devices, there is an upward—effect.

Mr. JORDAN. Right.

Mr. PETRICONE. You know, I mean, if somebody doing this to my company, than I am certainly going to do this to your company.

You know, and you have 50 States, and you have got municipalities and—you know, so there are potentially dozens and dozens of jurisdictions where these may be enacted.

Mr. JORDAN. Right.

Mr. PETRICONE. So we are afraid—right now, you can say it is only a dozen States, what is the big deal. But we are convinced that, left to its own devices, it is going to worse. I mean, the condition is there for it to get worse.

I can also add——

Mr. JORDAN. You know, that is the nature of government.

Mr. PETRICONE [continuing]. Right. And, of course, there is every political incentive to export your tax burden, sir.

Even at the present time, there are a few issues; Congressman—gets many calls from our small business members saying, you know, this just happened to me, this is terrible, what can I do.

And at present, there is not a lot I can tell them.

Mr. JORDAN. Go ahead. I have got one more question for Mr. Petricone, but go ahead.

Mr. DUCHARME. I think the discussions that we have had internally at Monterey have centered around, you know, what is the rationale for this process; how did it begin?

And it all stems from, and it is our opinion that it is the constraints that State budgets are having that they are looking for additional revenue.

This seems to be a short-term solution to a long-term issue.

Monterey Boats, all activity occurs in the State of Florida.

We have independent sales reps that are not employees of Monterey, so we don't benefit from any of the resources of the States that we deliver boats into.

We pay income, sales, property, real property taxes in the State of Florida. We pay for permits and fuel taxes in the various States that we deliver to.

At the end of the day, our activities within all these States that are imposing tax on us, we don't actually benefit from. The ultimate buyer, yes, they do; but we, as a corporation, do not.

Ms. SÁNCHEZ. The time of gentleman has expired

I just wanted to make sure the witnesses have your mics on when you are answering questions. For recording purposes, we need the mics on even though we can hear you.

At this time, I would like to recognize the Chairman of the full Judiciary Committee who has joined us, Mr. Conyers, for 5 minutes of questions.

Chairman CONYERS. Thank you very much, Chairwoman Sánchez.

What a great afternoon here to have standing-room-only.

Why is it that Subcommittee number five always seems to attract more attention than all the other great Subcommittees that exist on the Judiciary Committee?

Ms. SÁNCHEZ. It is because of the Chairwoman, I think. That is the short answer, Mr. Conyers.

Chairman CONYERS. Well, the Chairwoman is correct herself.

Look, when we started here in the 110th Congress, nobody wanted to go on Subcommittee number five. Now, I am still getting requests for people that ask me to enlarge number five, can they get on it for next year, and it goes on and on and on.

More subpoenas and authorizations for subpoenas come out of this Subcommittee than any other—than all the other Subcommittees on the Judiciary Committee.

Look, and here we are this afternoon, standing-room-only, offices on K Street, Pennsylvania Avenue, L Street, Georgetown, are left lane barren. And everybody is here.

I look across the room, the only ones that aren't here are Members of Congress that have offices in those places that I just named.

And so we know that something important and significant and serious is afoot here.

Now, what to do?

Well, let us have some fairness for the business community. Okay. But let us remember that the States are catching hell. Most of them are insolvent. And so what should we do?

Well, it devolves upon this powerful Subcommittee under the distinguished leadership of the gentlewoman from California to urge that there be further negotiations after this splendid hearing this afternoon.

We have got to start talking with some people. Here, we have wonderful divisions here. We heard our first two colleagues on the Committee. They are joined by Messrs Pence and Gallegly.

And, of course, the distinguished gentlelady from California, Ms. Lofgren and former magistrate Hank Johnson.

I mean, the only few people hanging out here uncommitted are the gentleman from Massachusetts and the acting, Ranking minority Member here and myself.

And so we would like the results of this hearing to be the predicate for some other discussion in which we try to resolve what is the central dilemma.

Sure, let us protect business. But tell me what I tell Governor Granholm when I go back to Detroit just what we did. We just relieved you of millions of dollars of taxes that would have been coming into Michigan because of the benevolence of the Subcommittee number 5 and this work it sent to the full Committee.

That may present a difficult situation.

So what advice do you witnesses have here for a person in my predicament?

Ms. SÁNCHEZ. And I would note that the witnesses have 5 seconds to answer Mr. Conyers' question. [Laughter.]

Chairman CONYERS. Well, I yield back the balance of my time. [Laughter.]

Ms. SÁNCHEZ. If anybody would like to take a crack at that briefly?

Mr. Quam?

Mr. QUAM. Congressman, I think you make a very good point. Taking money away from the States right now is a very bad idea.

States, of course, have to balance their budgets, so taking $6 billion out of State economies would actually hinder States' ability to recover even from the economic downturn we are in.

A State such as yours, I think the estimate is almost $500 million under this bill that would be to be filled by the State, a State that is having difficulty.

And I know that the governor has communicated that to you. Governors are always willing to talk. I think discussions can be warranted. They have to be balanced.

Clarity and uniformity has to be balanced against State sovereignty and revenue needs. If those discussions can take place with balance, there is probably some place to go.

However, unfortunately, up until now, we haven't had a bill with us that suggests that balance.

I think discussions within that framework are possible. They are going to take some work. But I thank you for your comments regarding this bill and the condition of States.

Ms. SÁNCHEZ. Mr. Johnson?

Mr. JOHNSON. I would just like to make one brief point.

In my view, this is not so much a business versus States bill; this is a multi-state, sophisticated, large business versus local business.

In Utah, every dime we get from the income tax, the corporate income tax and the individual income tax, go to educate our children.

We are going to have to get that money from somebody. If we can't get it from multi-state businesses, we are going to have to get it from our individual taxpayers or our local businesses.

That is, to me, where the rubber hits the road on this one.

Ms. SÁNCHEZ. Thank you.

Mr. Petricone?

Mr. PETRICONE. Mr. Chairman, I appreciate you being here, and I appreciate the very articulate way you put forward the very legitimate concerns of the States.

Many of the business we represent are small businesses. They are trying to create jobs, and they are trying very hard to keep their heads above water in a very, very tough economy.

And they are being hit by these taxes in States, sometimes, they hardly knew they were doing business in.

And, you know, I am getting calls on a regular basis by members who want to know what to do.

Small businesses operate close to the bone. They are now in a position to comply with multiple taxing entities and multiple tax jurisdictions.

So I would simply ask that you and this Committee, you know, do everything you can to come up with an environmental solution that is fair to the States who have legitimate revenue needs but also to businesses and small businesses that are trying to create jobs and keep on moving forward.

Ms. SÁNCHEZ. Thank you.

At this time, I would like to—Mr. Ducharme, did you want to add anything?

At this time, I would like to recognize the gentlewoman from California, Ms. Lofgren for 5 minutes of questioning.

Ms. LOFGREN. Thank you, Madam Chairwoman, and thank you for holding this hearing.

I do think the hearing is an important one. There are important issues presented by all the witnesses here today.

I actually think—I co-sponsored the bill. I do think that there is lack of clarity in the law on what constitutes sufficient nexus for taxation.

It is pretty clear the Supreme Court is not going to provide clarity, so that means that if there is going to be some clarity, probably, we need to play a role.

As Mr. Conyers has just said, and I think you are noting, there is room for the States and the business community to come together on this issue and reach an agreement.

And I think, you know, it is possible, but we have a role to play in helping that to happen. If so, I am willing to do whatever part is necessary. Whether or not agreement is reached, I think further exploration would be of enormous value.

You know, my State of California has a $19 billion budget deficit and getting larger. I know that if we had the same income tax rates that we had when Ronald Reagan was governor, basically, we wouldn't have a deficit.

So there are many things that States can do, and I am mindful that it is, oftentimes, easier to tax the guy who isn't in your State than the guy who is in your State and who has a presence.

So that is not necessarily the right and responsible way to deal with a budget crisis.

I was in local government—I am only going to be able to say this for 6 more months—longer than I have been in the House of Representatives, so I am not hostile to the need to get revenue into public services. It is very important.

But we also need to foster a decent business environment.

I was wanting to see the letter sent by New Jersey. Apparently, we don't have a copy of it. Hopefully, we can get that later.

But, Mr. Ducharme, can you explain what the representation was made by New Jersey in that letter?

Mr. DUCHARME. Can you clarify for me the initial jeopardy assessment letter that we received or the notification?

Ms. LOFGREN. Mr. Johnson said that the State of New Jersey had sent a letter for this hearing. Apparently, it cannot be found anywhere. Well, you haven't seen it either.

Mr. DUCHARME. We received an acknowledgement letter from the State of New Jersey notifying us that we had been scheduled a date for the Conference and Appeals Branch.

Ms. LOFGREN. All right.

Mr. DUCHARME. Is that the letter that you are referring to?

Ms. LOFGREN. I don't think that is what Mr. Johnson was referring to. Maybe I can ask Mr. Johnson.

What was in that letter?

Mr. JOHNSON. Yes. If I may, I have a copy of a letter that is addressed to the Honorable Linda Sánchez from the State of New Jersey dated June 18, 2008.

Ms. LOFGREN. I think you are the only one who has that letter, so I would love to see it if I could.

Mr. JOHNSON. We will certainly be pleased to provide copies to the Committee.

Ms. LOFGREN. Maybe the clerk can get it now so I can take a gander at it.

I am wondering, Mr. Petricone, when you talk about intangible and the kind of crazy quilt that we have now, why do you think that the bill that we are pursuing now actually provides the relief that is necessary in terms of uniformity, and how will that not disadvantage States?

Mr. PETRICONE. Because, Congresswoman, at the very least with this bill, everybody is playing under the same rules. There is a definition of physical presence; everybody understands what it means.

Small businesses and businesses in general know what their liabilities are and who they can be expected to be taxed by.

The element of certainty is very important to us.

Ms. LOFGREN. It just strikes me that the—our country was set up in a way to not constrain commerce between the various States because we are the United States of America. We are not a pre-E.U. Europe.

Although this was never intended, perhaps, to disassemble that unity. In fact, if you start taxing entities for driving through a State, you are burdening, really, the economic entity that is the United States.

So I think this measure is, you know, maybe it is not the perfect bill. I am happy to be a co-sponsor, but I think the principle—is enormously important, and I think that if the parties can come together and come to some agreement, that would probably be the best possible outcome because everybody has got an incentive.

I mean, if we move forward, States are just afraid they will lose, and I think that is a likely outcome unless we can come up with some resolution.

So I think everybody should be motivated.

I thank the gentlelady for recognizing me.

Ms. SÁNCHEZ. The time of the gentlelady has expired.

At this time, I would like to recognize Mr. Feeney for his 5 minutes of questions.

Mr. FEENEY. Well, I thank the Chairman, and I will be brief.

I was only able to attend the last few minutes of the hearing, so I don't want to be duplicitous of anything that has been asked.

I should say that I have been a long-time supporter and co-sponsor of the act that is being considered today.

And I have had a chance to review some of the testimony.

You know, there is an old rhyme—I spent 12 years in the State legislature—that when it comes to raising revenue, the best way to do is, according to the rhyme, don't tax you, don't tax me, tax the guy behind the tree.

And unfortunately, the guy behind the tree, all too often, is the person who is not there physically to defend himself, whether it is in the halls of the lobbyists on the last night of a legislative session or whether it is because they literally do not have a physical locus in the State.

And, you know, I would suggest there are a couple constitutional protections of the so-called dormant clause to the commerce clause which has been resurrected in the *Quill* Case and, of course, I

think also the 14th amendment has some protections for people that are hit from one State with a tax that impacts them.

Having said that, we have got some States that are understandably, including my State of Florida, had to cut about, oh, 10 percent of expenditures this year from about a $70 billion total State budget to $63 billion.

So understandably, States are under pressure to raise revenues. But I think in order to have a balanced playing field to promote interstate commerce and to promote fair play, this bill strikes an important balance so that States have plenty of revenue options available to them, but basically taxing people that do not have a physical presence or, you know, I think has some fundamental problems.

I do note that we have a Florida businessman here, and so you have had some experience with New Jersey and, perhaps—have you had any other States that have aggressively tried to pursue collection of taxes from you?

Mr. DUCHARME. The State of Washington, the State of Michigan, the State of New Jersey, and inquiries from South Carolina and Maine.

Mr. FEENEY. And given your experience, I guess I would just ask you to sort of speculate other types of businesses, maybe not boat manufacturers or your specific business, the uncertainty in the law with 49 States that you may ship to or have ancillary business with but are not physically located in, what type of uncertainty—what type of problems does that create for a business regardless of where they are actually physically located?

What types of potential problems does that create as you are trying to create a business plan, trying to create, plans, a manufacturing facility, borrowing money to expand your business and, hopefully, create jobs.

What type of planning dilemmas does that create for a small business person trying to grow into a mid-sized business or a large business?

Mr. DUCHARME. That is a good question.

The biggest and most pronounced issue is going to be the burden of the accumulated costs that we would incur from hiring staff to wrap their arms around and get an understanding the various States tax issues.

Hiring and retaining accountants and tax attorneys and attorneys within each State would become a burden that, under the current economic situation, would be very difficult to pass along in the pricing of our, in our case, our boats.

Mr. FEENEY. Well, I think that is a great point, you know, to have 50 different sub-accounting departments and tax-planning departments just to make sure you weren't violating somebody's laws somewhere would create a horrendous choice for small businesses trying to grow and make their products available.

So with that, Madam Chairman, I think this bill, you know, strikes a good balance and I thank all of our witnesses and would be happy to yield back the balance of my time.

Ms. SÁNCHEZ. The gentleman yields back the balance of his time.

At this time, I would like to recognize the ever-patient gentleman from Massachusetts, Mr. Delahunt for 5 minutes.

Mr. DELAHUNT. Well, thank you so much for that kind and generous introduction.

I have been attending these hearings—I should direct this to the Chair—long before you came to Congress. As Yogi said, "It is deja vu all over again."

I am disappointed to hear, Mr. Quam, that your phone rang only once since my last admonition.

Other witnesses have testified, and I concur, that we are dealing with a different economy. This is a modern economy. The Internet is playing a more and more significant role, and we have to adjust.

But there is also a political reality here, and I think you, Mr. Ducharme and Mr. Petricone, have recognized it. That is, that nothing is going to happen with this bill until there is some accommodations.

You know, I just hear the arguments so eloquently put forward by my friend from Florida about the complexity of it all and the burdens that, particularly, small business have to endure.

And the reality is that I think there is sentiment that supports dealing with that.

And I would use the example of the SST—and Mr. Johnson, you are very familiar with that, and you are, Mr. Quam—where there has been substantial progress made to resolve that in favor of the business community to make it more simple.

But what I see is a lack of political will on the part of the stakeholders to come to the table and to achieve a, I think, a potential consensus that you can all work with.

I find it interesting that those that speak out in support of the business activity tax reform, let us call it, are reluctant to express their support for the streamlined sales tax when, really, they are all part of the same concerns.

There ought to be, I think—and I have said it before—a grand solution, if you will.

Was it you, Mr. Quam or Mr. Johnson, that indicated it is about $6-1/2 billion that would be lost revenue?

Mr. QUAM. Yes, sir.

Mr. DELAHUNT. What is the amount—what is the projected lost revenue to the States as a result of the *Quill* decision as it relates to the collection of the sales or use tax?

Mr. QUAM. Last estimates were around $30 billion.

Mr. DELAHUNT. $30 billion. So we would have a factor of five there.

You know, I am sure there are ways to achieve reconciliation on all of these issues.

I don't see this particular proposal—maybe it gets out of Committee—but getting it through the Senate and on a President's desk, I think you better go back and give it another shot and sit down and bring those other stakeholders that are not represented here with you to the tab and sit down with the governors and begin those conversations that could very well lead to a resolution.

And I think there are people on this Subcommittee and the gentlelady from California, Ms. Lofgren, offered her good offices. I am sure the Chair of the Subcommittee and the Ranking Member would also be willing to participate in, somehow, mediating—or

navigating is probably a more appropriate term—through this difficult, thorny issue.

Otherwise, you are going to have somebody sitting in this very chair 5 years from now, and there will be just be a different set of witnesses discussing the same issue.

So I think Congress is clearly inclined to be supportive, however, I don't see it as a major priority for this particular Congress.

The will and the intent has to be generated by those impacted.

With that, I will yield back.

Ms. SÁNCHEZ. The gentleman yields back the balance of his time.

I would now like to recognize my good colleague from the State of Georgia, Mr. Johnson for 5 minutes of questions.

Mr. JOHNSON OF TEXAS. Thank you, Madam Chair.

You know, there are various types of cutting instruments. You know, you have a meat cleaver that is, perhaps, a very fine cutting instrument to a butcher. Then you have a scalpel, which is a very fine cutting instrument to a surgeon.

When one wields a cutting instrument, one must be careful with the tool selection.

And I am not sure that the Supreme Court, on an issue such as this, is the kind of cutting instrument that is needed or is the type of butcher, if you will, or cutter. They are not the exact kind of cutter that is needed.

Certainly, you don't need a butcher on something like this, which means you don't need a meat cleaver.

And I am not sure that the legislative branch, with, you know, 435 House members and 100 Senate members can wield a scalpel with the precision that that cutting instrument requires.

But nevertheless, that is what we have. Some would say we don't have a scalpel; we have got a meat cleaver and it is just 435 people with meat cleavers trying to chop something up and make something better.

So I am saying that to say that, you know, the legislative branch, we certainly have the power to wield the meat cleaver. The judicial branch certainly has the wherewithal to wield a meat cleaver as well.

But it seems to me that with 50 State revenue representatives or representatives of States, and with the number of organizations that represent large and small businesses, it would seem that those entities would get together so that they would not fall victim to either the congressional or judicial wielding of a cutting instrument.

You just can't—you don't want to risk that. So this is the kind of situation, I think, that cries out for the parties to get together, using the offices of the Congress, to facilitate something that makes sense because times have changed since our constitution was ratified.

It is a living document, so that means it is going to be subject to interpretation depending on the times.

And certainly, times have changed. The commerce clause has held us in good standing and will continue to do so. But it is a matter of interpreting the time now and how we can have that constitution apply in a way that is efficient for business to operate and for America to have businesses, particularly, small businesses, that can compete in this global economy.

Small business is responsible for most of the job creation in this country, and I am torn because I support small businesses, but yet I am also sensitive to the needs of States and local governments to have sufficient revenues to do what we have to do to make life better for the people.

So I am really conflicted. I am a co-sponsor on this bill because I do know we have got to have good business for this country to remain strong.

And I will—I think most of the questions have already been asked and answered, and I won't ask you to answer them any more. But I will offer my humble offices and expertise should it be necessary for the parties to be able to sit down and talk together.

I will be happy to do whatever I can to help facilitate dialogue and discussion. I will yield back the few moments of time that remain.

Ms. SÁNCHEZ. The gentleman yields back.

We have concluded the hearing for today.

I want to thank all of the witnesses for their testimony.

Without objection, Members will have 5 legislative days to submit any additional written questions, when we will then forward to the witnesses and ask that you respond as quickly as you can so that they can also be made a part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any additional materials.

Again, I want to thank everybody for their time and their patience.

And this hearing of the Subcommittee on Commercial and Administrative Law is adjourned.

[Whereupon, at 2:38 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

ANSWERS TO POST-HEARING QUESTIONS FROM MARK DUCHARME, VICE PRESIDENT AND CFO, MONTEREY BOATS, WILLISTON, FL

Responses from Mark Ducharme
Chief Financial Officer, Monterey Boats

to

The Honorable Linda T. Sánchez
Chair, Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives

Regarding Hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008"
June 24, 2008

Q: Thank you for describing your company's experience with three different states and their business activity taxes. Have you spoken with other boating companies who have experienced similar circumstances? Would you please describe for us what you have heard?

A: Monterey Boats has had numerous conversations with other companies throughout our industry who have had similar experiences. There literally are dozens of examples of manufacturers of recreational boats and recreational marine accessories that have been assessed state taxes on revenue generated from the wholesale sales of their products to third parties in a state. The nexus standard used to establish this tax obligation typically is so broad that small businesses may be required to file tax returns in dozens of states at significant expense. The examples I have discussed with others in the industry typically fall under one or more of these three categories:

1. Warranty service provided by third parties: An out-of-state manufacturer contracts with a marine dealer to perform repairs to equipment or boats that are covered under the manufacturer's warranty. Although the manufacturer has no sales team and no physical presence in the state, it is deemed to have established nexus because it has paid an independent, in-state contractor to perform these repairs. In this instance, state officials have claimed that the image of a brand is enhanced when warranty service is performed and this "brand-building activity" constitutes the establishment of nexus by the brand owner.

2. Sales to marine dealers: States frequently have determined that nexus has been established by an out-of-state manufacturer even when a marine dealer purchases the manufacturers products and pays for the shipping of inventory to him. For example, a marine dealer orders five boats from an out-of-state manufacturer. The boats are delivered, with the dealer paying the transportation costs. Numerous boat builders have been assessed business taxes in the state where these products are delivered under the theory that the manufacturer's brand is being "promoted" in the state through sales generated by the in-state dealer.

3. Manufacturer representatives at boat shows: Boat shows are venues in which local marine dealers rent space, present their inventory to the public and either complete sales on site or in later transactions that occur at a dealership. Manufacturers may at times attend the shows to answer questions and to give consumers a sense of the company that manufacturers the product. If these manufacturer representatives stay in the state beyond a very few days, typically about one week, the manufacturer could be ruled to have established economic nexus and be assessed taxes on all sales into the state for that year

Q: You indicate in your written testimony that you have not received a response to your proposed resolution to clarify your responsibility with New Jersey. That was October 2006. Have you contacted the state since then? What has been the state's response, if any, to why the situation has not been resolved in 20 months? Have you had to pay further taxes to New Jersey since then?

A: We have made several attempts to have substantive conversations with the New Jersey tax authority in order to receive meaningful guidance since our first appeal to NJ Department of Treasury via a formal conference with state-appointed conferee. Monterey Boats has not received any reply regarding our proposed resolution to this matter. At this time New Jersey has not provided authoritative guidance to our company nor have state officials been responsive to our requests and proposals. As a direct result, our company has not felt compelled to pay NJ Corporate Business Tax until we receive authoritative guidance from the state.

Q: Earlier this year the New York State Bar Association recommended that Congress establish a clear nexus standard for a state's imposition of a business activity tax. It suggested that the standard take into account economic presence rather than a pure physical presence test, and, most important for small businesses, include a reasonable de minimis threshold before imposing a tax on a business. Would you support such a hybrid model, where the threshold would provide clarity for small businesses? Why?

A: While a bright-line standard would remove some of the ambiguity that is prevalent today, we would not support such an approach for two reasons. First, it would establish an inequitable tax burden on companies and small businesses because a remote seller would be paying for government services and protections that it does not receive. Second, for companies that sell to foreign customers, I understand that that if the U.S. law were to change to allow taxation due to the mere presence of customers, our country's tax arrangements with foreign countries might then change, too, and those companies would be exposed to foreign tax liabilities. It is my strong belief that the most reasonable and equitable test to establish tax liability in a state is through physical presence. Such a standard eliminates ambiguity, reduces complexity and provides tax fairness to an array of businesses, especially small businesses. A clear physical presence test—as opposed to an ambiguous economic test—allows for the equitable distribution of tax revenue to those jurisdictions in which a business receives government benefit, while preventing states from overreaching thse constitutional limits of their taxing authority.

Q: During his testimony at the June 24 hearing, Mr. David Quam stated the following: "Under this bill [H.R. 5267], you can do the type of tax planning where you can have two toy stores next to each other; one who has the means to hire the tax counselors to actually exploit the loopholes in this bill. And all of a sudden, you have the same stores physically present in the state, one paying business activity tax and one not." Please respond regarding the fairness in the tax liabilities for the two toy stores in the example Mr. Quam gave.

A: This criticism seems unreasonable to me given that the bright-line standard Monterey Boats and the others advocating for sensible reform on this issue is a "brick and mortar" physical presence test. If the two companies identified in this hypothetical example both have physical presence in the state, as which would be the case were the Business Activity Tax Simplification Act to become law, then both were be subject to appropriate taxation. The physical presence test is not a loophole. What is currently unreasonable and unfair is the manner through which certain states are aggressively attempting to collect revenues on businesses that have no operations in their state, and thus which receive no benefits in that state. This creates a degree of complexity and exposure that unnecessarily increases the cost of doing business and interrupts commerce. Contrary to Mr. Quam's example, the physical presence standard and

other provisions outlined in H.R. 5267 would substantially reduce abusive state tax assessments that take advantage of smaller businesses that have no reasonable ability to ascertain their tax liabilities in states in which they have no actual physical presence, or to subsequently challenge these unlawful assessments if they occur. Extending Mr. Quam's example and applying it the status quo, the toy store that can afford a tax team is better able to counteract unlawful state tax assessments than the toy store that cannot afford such tax representation—in other words, the inequity Mr. Quam identifies exists now. A clear physical presence standard would eliminate ambiguity and provide tax fairness through clarity. Small businesses already face significant hardship from economic nexus criteria, as they are inequitably burdened by administrative costs as well as the likelihood that the fines, back taxes and interest they have been assessed are less costly than combating the assessments in court. Therefore, these small businesses are significantly harmed by current state actions.

Additionally, it is important to note that H.R. 5267 would provide predictability, consistency and certainty, not create new "loopholes." The current confusion over inconsistent and varied nexus standards among certain states discourages business in that state, harms commerce and exposes businesses like my company to unreasonable and unlawful tax assessments.

ANSWERS TO POST-HEARING QUESTIONS FROM R. BRUCE JOHNSON, COMMISSIONER, UTAH STATE TAX COMMISSION, SALT LAKE CITY, UT

State of Utah

JON M. HUNTSMAN, JR.
Governor

GARY R. HERBERT
Lieutenant Governor

Utah State Tax Commission

PAM HENDRICKSON
Commission Chair

R. BRUCE JOHNSON
Commissioner

MARC B. JOHNSON
Commissioner

D'ARCY DIXON PIGNANELLI
Commissioner

RODNEY G. MARRELLI
Executive Director

September 25, 2008

Mr. Adam Russell
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U. S. House of Representatives
2138 Rayburn House Office Building
Washington, D.C. 20515-6216

Re: H.R. 5267--Response to the Questions Posed by Linda T. Sanchez, Chair

Dear Mr. Russell:

Following are my responses to the questions posed by Chair Sanchez. Please express to her and the other members of the Subcommittee my appreciation for their attention to this important matter.

1. The state of Utah apparently asserts business activity tax nexus over a nonresident company if the company is listed in the local telephone books of your state or when it makes a loan secured by real estate located in your state. Please explain how that creates a sufficient nexus for tax obligation purposes.

A telephone book listing, in and of itself, may not create nexus. But a listing is one piece of evidence that a taxpayer is establishing and maintaining a market. Of course, if the number is an in-state phone number, it effectively means the taxpayer has a sales office in the state. Thus, a company that has sales representatives in the state that it believes are within the P.L. 86-272 protection provided for "solicitation," will not normally provide a telephone listing for those employees, because a sales office, even if located in an employee's home, is outside of the protection of P.L. 86-272. Even if the phone number is a toll-free number or a standard out-of-state number, however, the existence of the listing denotes a certain level of market activity in Utah. And a significant market in a state does create nexus in our view.

A loan secured by real property gives the lender an interest in that real property. The state in which that property is located spends resources to protect the property. In doing so, the state protects the value of that property for all the interest holders, each to the

extent of its interest. The lender files the lien with the appropriate state or county office where the property is located for the express purpose of invoking the state's protection of its security interest. The filing not only establishes legal rights enforceable in Utah courts, it puts other creditors on notice of the priority of the original lender's interest. Thus, the mere fact of providing a venue for recording the security interest is a valuable service performed for the lender by the state, even if a default never occurs. All interest holders - whether they hold an ownership interest or something short of that - have a property interest located in the state, benefit from the state protections, and thus have nexus with the state.

2. You assert in your written statement that H.R. 5267 would "create tax-planning opportunities for large businesses to eliminate state taxation of revenues earned in a state." First, are these opportunities limited only to large businesses? Second, please provide an example of one of these tax avoidance opportunities.

There is nothing in the bill that would specifically limit tax-planning opportunities to large businesses. As a practical matter, however, for a business to benefit from tax planning, it has to have enough tax liability at stake to justify paying tax planners, attorneys and accountants and undertaking the corporate restructurings necessary to achieve some savings. It is usually the larger businesses that have the tax liability and can generate the tax savings sufficient to justify those expenditures. Small, in-state only businesses have fewer nexus planning options and are generally subject to tax on 100% of their net-income. Small multistate corporations with presence in a state will likely not have the tax savings potential that would justify the expense of advisors and restructurings. For example, a large company, with significant resources, can afford to have a "treasury function" located in a tax- favored state, or even offshore. A smaller company, with less invested capital, cannot afford that luxury.

Moreover, large businesses are more likely to be integrated enterprises than small businesses. In other words, they are more likely to manufacture, distribute and sell products, whereas smaller businesses are more likely to perform only one or two of those functions. A business with both manufacturing and sales activities can more easily avail itself of entity isolation strategies, such as the "sales affiliate carve out" described below.

One simple example of this type of tax avoidance opportunity is a "sales affiliate carve-out." To understand how a "sales affiliate carve-out" works, take the case of a corporation that has both a factory and sales in a state. Today, that corporation would pay tax on whatever share of profit from its entire enterprise is attributable to that state. But if sales do not create nexus, which they would not under H.R. 5267, that corporation has an incentive to restructure itself into two entities. One entity would run the factory

and would be taxable by the state. The other entity (the sales company) would not have nexus under H.R. 5267 because it only sells the product into the state. The manufacturing company could sell its product to the sales company at an arms length price and pay tax to the state on only the production portion of the enterprise's net income. The sales company could then sell the product to consumers in the state at a market price, but because the sales affiliate would be protected by H.R. 5267, it would not be required to pay tax to the state on the profits it earns from the sales portion of the enterprise. (If the production affiliate charged the sales affiliate less than an arm's length price, the tax base for the production affiliate would drop even lower. It is very difficult to determine arm's length prices.)

Another strategy that is widely used is the "intangible holding company." A national retailer, such as Toys-R-Us, creates a holding company in a tax favored state to hold its trademarks. It then has its local stores pay a royalty to the holding company that effectively reduces or eliminates its taxable income in the state where the store is physically located and the sales are made. The holding company can then loan the royalty back to the local store which then has the cash, plus another deduction for interest expense. This strategy was rejected by the South Carolina court in *Geoffrey, Inc. v. South Carolina*, 313 S.C. 15, 437 S.E.2d 13 (S.C. 1993), cert den., 510 U.S. 992 (1993), but passage of H.R. 5267 would undoubtedly encourage variations of this structure. Manufacturing companies could achieve similar tax savings by transferring patents to the holding company.

Proponents of the bill say a state could use "combined reporting" to remedy this situation. That is not entirely true. First, only about 50% of states with a corporate income tax use combined reporting. It's possible state legislatures across the country could all revise their corporate income tax laws to get around this particular planning opportunity of H.R. 5267. But, what is to be gained by the federal government passing a law that simply requires states to go through the process of changing their own laws to get around it?

More importantly, H.R. 5267 would give rise to many tax loopholes that states would not be able to address through state legislation. For example, subsidiaries, including intangible holding companies, could be set up off-shore, where they would not be subject to the combined reporting regimes of most states. On the international level, these strategies also reduce federal income taxes and Congress is considering ways to stem these abuses. See, for example, the Stop Tax Haven Abuse Act (S. 681). It makes no sense to prohibit these abuses at the federal level and legitimize them at the state level.

H.R. 5267 would prevent a state from taxing any corporation that arranges its affairs so neither it nor its affiliates create any jobs or place any investment in the state, even if the corporation and affiliates are making millions of dollars of sales into the state. This is the main impact of the bill and there is no way to get around it through state legislation. It

gives corporations a strong incentive not to create jobs and investment in states in which they are doing business.

3. Reports estimate that the states would lose billions of dollars a year if legislation establishing a physical presence standard for business activity taxes was enacted. Please explain why the states would lose this amount of money, because seemingly the businesses still have to pay an equal amount in taxes to the states in which they have a physical presence.

Some states choose not to impose traditional corporate income taxes. That is a legitimate policy decision for those states. If H.R. 5267 is passed, companies will create intangible holding companies, sales corporations, or other entities in those states. These strategies are described above. Without changing the practical way in which they do business, these artificial restructurings will allow corporations to shift income from the state in which it is actually earned to a handful of states that choose not to impose a tax. This will result in an overall reduction of their income tax burden. It is disingenuous to argue that corporations are supporting H.R. 5267 merely to redistribute the taxes they already pay. They clearly understand there will be an overall reduction in their state tax burden.

More to the point, even if it were true that H.R. 5267 would simply consolidate the tax base in a few states, from any particular state's point of view, and from the point of view of the taxpayers of that state, the distribution of the tax burden is still unfair. I reiterate the example of the bank I used in my oral testimony. A Utah bank with 10,000 credit card holders is required to pay a Utah tax. An out-of-state bank, with 10,000 credit card holders in Utah, using the cards to finance Utah purchases, in direct competition with the Utah bank, should pay income tax to Utah also.

The states, following the guidance of the U. S. Supreme Court, have worked out apportionment formulas that their elected representatives feel properly attribute the tax base to the states where the corporation has activities. All states in which the corporation has activities should be able to rely on this tax base to fund the government benefits used by the corporation. Concentrating a corporation's tax base in only a handful of the states where it has bricks and mortar facilities would leave the rest of the taxpayers in the rest of the states to take up the slack and cover the entire funding responsibility.

4. Earlier this year the New York State Bar Association recommended that Congress establish a clear nexus standard for a state's imposition of a business activity tax. It suggested that the standard take into account economic presence rather than a pure physical presence test, and include a reasonable *de minimis* threshold before imposing a tax on a business. Do you agree with the Bar Association's recommendation? Why?

We do agree with the Bar Association's state tax policy recommendations that economic presence should be taken into account. We also agree that a reasonable *de minimus* threshold is appropriate. We do not agree that uniform limitations or formulas should be imposed on states by the federal government.

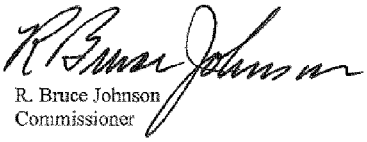
The Multistate Tax Commission has drafted a model nexus rule that meets these policy recommendations. Under the proposal, most multistate companies with limited (or no) amounts of property or payroll in a particular state would have no tax obligation to that state if their sales into the state were under $500,000 per year. Some states have begun to consider the proposal in their legislatures. There is a reasonable likelihood this proposal will be enacted in state legislatures if groups like the New York Bar Association and other taxpayer organizations express their support.

5. You provide in your written statement an updated chart of estimated revenue losses for several states. You list California as losing about $45 million for fiscal year 2010, and New Jersey losing about $366 million for fiscal year 2010. Why such a disparity when we know that California has a much larger economy than New Jersey?

The numbers we provided were based on reports from the individual states based on their individual tax systems and economies. Although we attempted to provide uniform guidelines, each state used its own personnel to prepare its estimates. Having said that, we believe that much of the disparity is due to the fact that California has chosen a "combined reporting" method for calculating corporate income taxes and New Jersey uses an alternative "separate entity" method. Separate entity states are particularly vulnerable to the tax avoidance schemes discussed above. Many separate entity states are now considering a shift to combined reporting, but there has been strong opposition from taxpayer groups.

If you have further questions, or if I can be helpful in any way, please let me know.

Respectfully submitted,



R. Bruce Johnson
Commissioner

ANSWERS TO POST-HEARING QUESTIONS FROM MICHAEL PETRICONE, VICE PRESIDENT, TECHNOLOGY POLICY, CONSUMER ELECTRONICS ASSOCIATION, ARLINGTON, VA

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January 22, 2009

The Honorable Linda T. Sánchez
Chairwoman Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives
Washington, DC 20515

Dear Chairwoman Sánchez:

Thank you for the opportunity to appear before your Subcommittee last year in support of the Business Activity Tax Simplification Act (BATSA). In response to your request for additional information, please find my response to each of your questions:

1. During the June 24 hearing, Chairwoman Sánchez asked you a question regarding the New York State Bar Association's recommendation that Congress establish a clear nexus standard for a state's imposition of a business activity tax. The Bar Association suggested that the standard take into account economic presence rather than a pure physical presence test, and include a reasonable *de minimis* threshold before imposing a tax on a business. Please respond as to your views on the Bar Association's recommendation.

CEA believes that a business activity tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer. As a global industry, consumer electronics companies routinely sell their products to customers in all 50 states and in many cases around the world. An economic presence standard would create a taxing regime in which companies pay taxes without receiving state and local benefits such as education, transportation, fire and police, an inherently unequal system.

2. How would enactment of H.R. 5267 provide more certainty for taxpayers and states alike than is currently the case?

As a growing number of states seek to extend the reach of their business activity taxes, businesses need a consistent regulatory framework by which to operate. To ensure such consistency across the country, BATSA would set a clear standard for physical presence. For a business with customers in multiple states, a bright-line physical presence standard as outlined in H.R. 5267, allows a company to anticipate their operation costs and alleviate any uncertainty. In today's challenging economy, this assurance is critically important.

3. Congress enacted P.L. 86-272 in 1959 to provide certainty to interstate sellers of tangible personal property with respect to their liability for state income taxes. Although our economy has grown to a more service-based economy since 1959, Congress chose not to protect the service transactions and intangible property in existence then. Why should Congress now extend the reach of P.L. 86-272?

Much has changed since Congress enacted P.L. 86-272 in 1959. For example, the Internet has dramatically reinvented interstate commerce, making it even easier to do business across state lines. HR. 5267 would modernize existing law to ensure that states can't impose a business activity taxes on an out-of-state business. Moreover, the production of intellectual property has largely replaced the production of tangible personal property in the United States since 1959.

4. Mr. Quam and Mr. Johnson suggest in their written statements that H.R. 5267 could provide opportunities for tax avoidance. How do you respond to those assertions? Could the bill be improved to eliminate such tax avoidance opportunities?

Our member companies are upstanding corporate citizens who understand the importance of state tax collections and do not ask for relief from legitimate taxation. If a business has a physical presence in a given state and is provided with benefits or protections by the state, CEA believes that the business should be subject to reasonable taxation.

Furthermore, the states already have a number of compliance tools to address any attempts at unlawful tax avoidance, including sham transaction restrictions and business purpose requirements, discretionary powers to adjust taxpayers' reported state net income, tax shelter reporting requirements, legislative add-backs of certain related party interest and royalty payments, and statutorily mandated combined reporting of a unitary group. The bill explicitly preserves the authority of the states to adopt or continue to use such tools. With these tools, state revenue departments and legislatures already have important mechanisms for reconciling the states' concerns over any use of "tax shelters" and the business community's need for the certainty of a bright-line, physical presence nexus standard.

5. Opponents of this bill assert that the bill does not actually benefit small businesses. Is that true? How does this bill protect and support small businesses?

On the contrary, small businesses will benefit greatly from enactment of H.R. 5267. The Internet has permitted small businesses to reach global markets. When states levy taxes on out of state business, small businesses are disproportionately impacted as they often do not have the resources to meet the demands of increased compliance costs and lack the resources to challenge ill-founded levies. BATSA would support small businesses by ensuring a fair and consistent regulatory treatment and a settled business environment.

6. In your written statement, you suggest that companies "face the risk of duplicative taxation." Are companies being double-taxed? Cannot companies apportion their income to several states to avoid double taxation?

While income is, indeed, apportioned by each state before its tax rate is applied, no two states' apportionment formulae are identical. Accordingly, businesses that operate in interstate

commerce run the risk of multiple taxation, which is only exacerbated by economic nexus because more states will have the opportunity to grab at the pie and take what each considers its rightful piece. Multiple taxation is the primary reason motivating those who support BATSA, which would promote ideals of fairness (*e.g.*, a business should pay tax where it earns its income, and it earns its income where it employs its labor (employees) and capital (tangible property)) and international conformity (*e.g.*, BATSA's physical presence standard is far more generous to state governments than is the permanent establishment standard adopted in all international tax treaties to which the U.S. is partner).

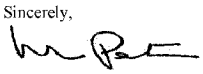
7. Supporters of H.R. 5267 advocate for legislation which would reverse decades of judicial precedent. Last year the Supreme Court denied *certioari* in two cases, *Lanco* and *MBNA*, on the issues before us today. Why should Congress pass legislation to establish a physical presence standard for business activity taxes which the courts have not supported, and on which the states have based their tax systems for decades?

Actually, the physical presence nexus standard in BATSA is consistent with the current state of the law. Pursuant to longstanding precedent, 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 taxpayer, whereas the Due Process Clause requires only a "minimum" connection. In Quill Corp. v. North Dakota, the Supreme Court determined that, in the context of a business collecting sales and use taxes from its customers, the substantial nexus requirement can only be satisfied 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. Since then, many of the state level decisions on the issue have concluded that there is no principled reason for there to be any lower nexus standard for business activity taxes than for sales and use taxes. These cases include J.C. Penney National Bank v. Johnson, 19 S.W. 3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); Rylander v. Bandag Licensing Corp., 18 S.W.3d 296, 298 (TX Ct. App. 2000); America Online v. Johnson, No. 97-3786-III, Tenn. Chancery Ct. (March 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).

Congress should step in with legislation to clarify this judicial split among the states and articulate a bright-line national nexus standard for imposition of state business activity taxes.

Thank you for your attention to this issue. If you have any further questions, please don't hesitate to contact me.

Sincerely,



Michael Petricone
Senior Vice President, Government Affairs

POST-HEARING QUESTIONS SUBMITTED TO DAVID C. QUAM, DIRECTOR, OFFICE OF FEDERAL RELATIONS, NATIONAL GOVERNORS ASSOCIATION, WASHINGTON, DC

QUESTIONS FOR DAVID QUAM

From Linda T. Sánchez, Chair

1. How have state courts decided this issue? Is there a split on economic presence and physical presence standards?

2. I have heard stories about some companies being taxed by a state in which they are not located simply because the company maintains a website on a server located in that state. If that is true, please explain how that creates a sufficient connection for tax obligation purposes.

3. In Mr. Petricone's written statement, he states that "companies face the risk of duplicative taxation." How do states ensure that companies are not taxed twice or more on the same income?

4. Several studies estimate that the loss of state revenue due to an imposed physical presence standard would be anywhere from $500 million to $8 billion annually. Would you please explain why there is such a large range in estimated losses for states?

5. Earlier this year the New York State Bar Association recommended that Congress establish a clear nexus standard for a state's imposition of a business activity tax. It suggested that the standard take into account economic presence rather than a pure physical presence test, and include a reasonable *de minimis* threshold before imposing a tax on a business. Do you agree with the Bar Association's recommendation? Why?

6. Mr. Ducharme described his company's situation with several states, including New Jersey. I have heard similar stories about New Jersey stopping the shipment of other companies' boats. If you know, please explain how and why this situation happens.

7. During the June 24 hearing, you stated the following: "Under this bill [H.R. 5267], you can do the type of tax planning where you can have two toy stores next to each other; one who has the means to hire the tax

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Note: The Subcommittee had not received a response to these questions prior to the printing of this hearing.

counselors to actually exploit the loopholes in this bill. And all of a sudden, you have the same stores physically present in the state, one paying business activity tax and one not." Please detail the loopholes which could be exploited.

STATEMENTS SUBMITTED FOR THE RECORD

Testimony of 303 Products, Inc.

United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

June 24, 2008

Ms. Chairwoman and Members of the Subcommittee, thank you for holding a hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008." H.R. 5267 represents an opportunity to protect small businesses from the "creative" tax schemes developed by some states to generate tax revenues from businesses, including more vulnerable small businesses that have no physical presence in the taxing jurisdiction. Essentially, H.R. 5267 would prevent states from redefining the constitutional limits on state taxation of interstate commerce and guard against the resulting threat to the development of our national economy.

Perhaps the best way to share with this subcommittee the difficulties faced by small businesses as a result of the current hodgepodge of business activity tax nexus standards claimed by the states is to tell you about our own experience.

It began like this: In the summer of 2006, we received a phone call from a person who said she was from the State of Washington. Not suspecting that being truthful eventually would bring harm to our company and to relationships with our major customers, and not at all aware that responding to the inquiry would result in extensive monetary expenditures for legal and accounting services, software and payment of overreaching state taxes on interstate sales, our staff member answered the caller's questions truthfully.

These questions included: Did 303 have customers in Washington?; Does 303 have sales reps calling on customers in Washington?; *etc.* Our staff person told the caller from Washington that 303 does indeed have customers in Washington, that product is shipped to Washington from our locations in California, and, of course, that 303 has contracted with independent manufacturer's representatives who call on customers in Washington. Our staff person explained that 303 serves customers in Washington in the same manner it serves its customers in every other state except for California … on an interstate basis utilizing independent manufacturer's representatives firms.

After the caller further explained that she was calling to determine if 303 was subject to a Washington corporate tax, 303's staff person truthfully advised her that 303 has never had an office or warehouse in the state. Our staff member also explained that the sales representative calling on accounts in the territory was not an employee of 303, but an independent contractor that served as a sales representative for several different manufacturers' lines. The caller from Washington stated that in order to determine if 303 Products, Inc. was subject to the tax, 303 Products was to gather and supply to her office

sales figures for our sales into the State of Washington. Our staff person then asked under what authority she was requesting this information. The woman calling from Washington replied that she would fax that information to us.

After discussing with our attorney the faxed documents and Public Law 86-272, we decided that our company was NOT obligated to supply data on our company's interstate business to Washington. A few months went by, and we received a notice from the State of Washington that a tax of $11,000 had been imposed. We ignored it. Why? Because no matter what was said or claimed, our company was a California company, not a Washington company. If the Washington State levy was legitimate, no doubt we'd hear further in due course.

In February 2007, our office called an Oregon customer, GI Joe's, about an overdue payment. The accounting department at GI Joe's informed us that they had paid the overdue amount, $3,900, to the State of Washington based on a "lien" they had received. We asked for a copy of that lien, which GI Joe's forwarded to us. It was our strong belief at that time that, not having a legitimate claim, the State of Washington could not attach our company's bank account. However, by intimidating our customers, Washington was able to force the issue and get their hands on company money indirectly.

To make a long story short, our attorney advised us that the best course, since a small business like ours can in no way take on a state government, was to give Washington the sales figures they asked for. Our office had no choice but to do so. Meanwhile, we found out that the State of Washington had sent the same threatening notice to a number of our larger retailer accounts, all of which had physical locations in the State of Washington. We eventually learned that Washington also sent such notices to our accounts in other states along the West Coast.

Eventually, the State of Washington determined that 303's sales to customers in the state were below the minimum statutory threshold and, therefore, no tax was due. At that point, we were able to release orders to GI Joe's that we had been holding for several months. From a small business perspective, you can see what a nightmare it was to navigate just the state of Washington's absurd approach to interstate taxation. I believe it is important to note that Washington's ultimate determination was based on a minimum financial threshold rather than substantive constitutional nexus standards or tax law. Essentially, Washington held our business hostage to determine if we made enough money to make their taxing financially worthwhile. How in the world is a small business supposed to operate in interstate commerce when states are allowed to create just about any theory to tax a business, without legitimate legal certainty, and then place liens, without notice, on assets? Clearly, the framers of our Constitution included the Commerce Clause to prevent the states from bullying and cajoling nonresident business into paying taxes based on novel arguments like "economic nexus." If the Congress does not step in to address this problem, there is no way that American small business can be expected to succeed.

The costs to our stockholders have been significant, and include legal and accounting fees and upgrading accounting software.

I'd like to add that after Washington posted the liens on our customer accounts, our office received no less than twenty telephone solicitations from legal and accounting firms wanting to "handle" the situation for us. I'm sure that Washington has tried the same tactics on many other nonresident businesses, and it's hard to imagine how much money is being coerced from the productive economy as a result of these aggressive state schemes.

Our company has no problem paying state taxes legitimately owed. However, we do strongly object to paying taxes to a state where we have no physical presence and from which we have received no benefit whatsoever. Disgust with a similarly unfair tax scheme and the same issues of taxation without representation inspired our forefathers to throw tea into the Boston Harbor.

Furthermore, it's important to note that Washington rightfully collects income taxes from our independent sales representatives in Washington (on money we pay them to serve in that capacity) and from retailers in Washington that sell our products (on profits they earn from the sale of our goods).

Ms. Chairwoman and Members of the Subcommittee, thank you for your time.

Yours Truly
303 Products, Inc.

Dennis A Praegitzer
President

July 2, 2008

The Honorable Linda T. Sánchez
House Judiciary Committee
Subcommittee on Commercial and Administrative Law
United States House of Representatives
Washington, DC 20515

The Honorable Chris Cannon
House Judiciary Committee
Subcommittee on Commercial and Administrative Law
United States House of Representatives
Washington, DC 20515

Dear Madame Chairwoman Sánchez, Ranking Member Cannon and Members of the Subcommittee:

The American Financial Services Association (AFSA) urges you to support H.R. 5267, the *Business Activity Tax Simplification Act* (BATSA), which would prohibit state taxation of an out-of-state entity unless such entity has a physical presence in the taxing state.

Based in Washington, D.C., AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Its 350 members include consumer and commercial finance companies, auto finance/leasing companies, mortgage lenders, credit card issuers, industrial banks and industry suppliers.

Federal legislation in this area is clearly needed. The Supreme Court has declined to rule on the "substantial nexus" standard as applied to business activity taxes. Thus, many state governments have filled the void left by the Court by creating a complex set of different tax rules.

BATSA will provide clear guidelines which will ensure fairness and create a secure business environment that will encourage businesses to invest and to expand interstate commerce. The legislation will also minimize expensive litigation for taxpayers and state governments.

Thank you for your attention in this matter.

Respectfully,

Bill Himpler
Executive Vice President, Federal Affairs
American Financial Services Association

June 24, 2008

Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

April 16, 2008

Statement for the Record
On Behalf of the
American Bankers Association
Before the
Subcommittee on Housing Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives
June 24, 2008

The American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record on the Business Activity Tax Simplification Act of 2008 (BATSA), H.R. 5267. ABA brings together banks of all sizes and charters into one association, and works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

Today, banks of all sizes face the growing problem and difficulties associated with the uncertainty of states' business activity taxes. The uncertainty in the application of the taxes greatly increases compliance and legal expenses that will ultimately be borne by customers and our economy at large. ABA strongly supports BATSA, which would modernize existing law to ensure that states and localities only can impose their business activity taxes in situations where an entity has physical presence (i.e., property or employees) and thereby receives related benefits and protections from the jurisdiction. ABA appreciates the leadership of Representatives Rick Boucher (D-VA) and Bob Goodlatte (R-VA) in introducing this legislation, and we encourage Congress to enact it in order to provide businesses with more certainty on this issue. There are three key points we wish to make on this issue:

- Inconsistent and unclear taxation standards between states subjects businesses to litigation and other onerous business costs, which are especially harmful to small businesses.
- Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs.

- BATSA will help minimize litigation costs and uncertainty for businesses by clarifying that entities must have a physical presence in the taxing jurisdiction in order to be subject to state and local taxes.

I. Inconsistent and unclear taxation standards between states subjects businesses to litigation and other onerous business costs, which are especially harmful to small businesses

An increasing number of states have enacted, or are considering, legislation that would lower the threshold of what constitutes "substantial nexus" for purposes of taxing a business' activity within the state. However, there is no uniform definition or application of "substantial nexus" among the states and no set rules or parameters for determining how a state would apply the nexus standard – it varies from state to state. Therefore, each state ***applies its own nexus standard*** to determine when an out-of-state business that is operating within the state is required to pay income tax. In fact, in some states, ***the presence of even one customer*** within the state would establish the state's required nexus for applying its business income tax to an out-of-state business.

This type of application of the nexus standard is devastating for small businesses, especially community banks, because they do not possess the substantial resources required to comply with a proliferation of disparate state tax laws. There are almost 3,000 banks and savings associations with fewer than 25 employees. Almost 800 of these have fewer than 10 employees. Many of these community banks operate near state borders and serve customers from more than one state. Additionally, many financial institutions now provide services to customers online, which allows people nationwide to take advantage of increased competition and better services to fit their individual needs. Without a uniform standard, these institutions are finding themselves subject to different standards that result in undue costs and burdens.

II. Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs

These additional costs resulting from the application of disparate standards divert resources businesses could invest in areas such as product innovation, improved customer service, or additional employees. Worse yet, businesses may be forced to offer fewer products and services at

higher costs, and some may actually cease doing business in states where additional tax burdens exist. 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. Consumers may experience reduced access to credit and increased credit costs. This could have even broader negative effects on individual states' economics and, possibly, the economy of a larger region.

III. BATSA will help minimize litigation costs and uncertainty for businesses by clarifying that entities must have a physical presence in the taxing jurisdiction in order to be subject to state and local taxes

BATSA would take away uncertainty by codifying in federal law that an actual physical presence in a state is required to create a substantial nexus. It 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. In addition, this bill would help limit businesses' exposure to unanticipated taxes, and thus reduce compliance and legal costs associated with frivolous nexus claims.

Consider the case of one ABA member that ***has operations in only four states, but is subjected to tax claims in 31 states***. To avoid burdensome legal costs, this institution has chosen to pay these claims, which last year amounted to roughly $3 million. This $3 million could have been put to better use in their local communities for providing homeownership or small business loans. Instead, the institution was forced to use these resources to pay burdensome taxes in states where it has no physical presence.

ABA strongly supports this legislation and hopes that Congress will work quickly to pass it. ABA applauds Representatives Rick Boucher and Bob Goodlatte who have introduced H.R. 5267 to address this issue of the lack of uniformity in the standard for taxing an out-of-state business's activity within a state. This bill provides a uniform definition for the standard to be employed by states in establishing whether an out-of state business should be subject to tax for activities conducted within the state, which will greatly help to streamline the out-of-state business activity tax within states and limit businesses' exposure to burdensome business activity taxes.

June 18, 2008

The Honorable John Conyers, Jr.
Chairman
Committee on the Judiciary
United States House of Representatives
Washington, DC 20515

Dear Chairman Conyers:

The American Home Furnishings Alliance urges your support for H.R. 5267, legislation to rationalize state taxation of out-of-state firms. As you are aware, the bill is the subject of a June 24 hearing in the Subcommittee on Commercial and Administrative Law.

In simpler times, manufacturing firms paid income and related taxes to the state where their "principal place of business" was located. This arrangement had the virtue of attributing income to the site (typically a plant) where it was generated. It also helped states recoup the costs of state services such as roads and sewers that manufacturing operations require.

As companies expanded their operations to include multiple plants, truck fleets, subsidiaries and franchises, it became more difficult to allocate income tax obligations to a single state. For a large company, several states might plausibly claim that the company's income derived from within their borders and that the state provided infrastructure and other resources to support company operations.

Since the middle of the last century, state governments have established a variety of tax systems directed at out-of-state firms. These are framed in various ways: as licensing fees, sales or use taxes, gross receipts taxes, and franchise taxes, but the net effect is similar.

The courts have allowed these assessments provided the non-resident firm has sufficient economic contacts or "nexus" with the taxing state to justify the latter's claim on a company's funds. Factors used in evaluating nexus traditionally included the presence of physical assets such as plants, sales offices, and real property (owned or leased), as well as the use of sales personnel and company-owned delivery vehicles within the state, and the provision of after-sales service such as repairs.

In recent years, cash-strapped states have asserted their taxing power against non-resident firms more aggressively. Tax claims have been justified by contacts that formerly would have been considered inadequate. Among these are the presence of independent sales reps, shipments by common carrier and the in-state use of sales tools such as fabric swatches. Based on such criteria, AHFA members have had truckloads of furniture impounded and held until multiple years of taxes-- plus interest and penalties—were paid.

A 2006 survey by the Bureau of National Affairs documented the increasingly strained interpretation of tax nexus being employed by state tax authorities. A majority of such officials said tax liability is appropriate if an out-of-state company makes deliveries in company-owned vehicles, or an employee visits the state more than four times in a given year. Thirty-two states contend that tax nexus should result whenever a non-resident firm accepts orders at a trade show. A handful even argue that merely registering to do business in a state or listing itself in a local phone book is a sufficient basis for taxation.

Predictably, some firms report they are steering clear of activities in states where they might otherwise do business. This is an unfortunate result, particularly at a time when business expansion and job creation are sorely needed. This is precisely the type of economic disruption that the Founding Fathers sought to avoid when they made the clause protecting interstate commerce one of the first provisions written into the U.S. Constitution.

H.R. 5267 would reaffirm some of the traditional criteria for establishing state tax nexus, including owning or leasing any real or tangible property, or assigning one or more employees to perform certain activities in the state for more than fifteen days in a taxable year. The bill would specifically bar tax claims against firms whose only instate activity is solicitation of orders.

We urge your support for H.R. 5267 and request its consideration by the full committee.

Russell B. Batson
V.P, Government Affairs
American Home Furnishings Alliance
(877) 278-2118, ext.103

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Defending the Interests of 76 Million U.S. Homeowners

Testimony

of the

American Homeowners Grassroots Alliance

Submitted to the

House Judiciary Commercial and Administrative Law Subcommittee

Hearing on

Business Activity Taxes

June 24, 2008

The American Homeowners Grassroots Alliance (AHGA) commends the House Judiciary Commercial and Administrative Law Subcommittee for holding this hearing on business activity taxes. AHGA is a nonpartisan consumer advocacy organization which focuses on policy issues that have a significant economic impact on the nation's 75 million homeowners.

Nexus is the key issue related to the application of business activity taxes as well as the obligation of Internet-based businesses to provide state and local sales tax collection services for the approximately 7,000 state and local taxing authorities outside of those businesses' home jurisdictions. Historically nexus has been defined as a physical presence, i.e. a physical facility such as a headquarters, warehouse, sales office etc.

Both business activity taxes and Internet sales taxes impact homeowners and other consumers. Business activity taxes are inevitably passed on to consumers, and consumers are obligated to pay state and local sales taxes directly unless those sales taxes are collected by a company with a nexus in the consumer's state and local jurisdiction. Among those companies are the growing numbers of home-based businesses, which now number 18 million, according to U.S. Census figures. For these reasons AHGA supports H.R. 5267, the Business Activity Tax Simplification Act of 2008 ("BATSA"), which would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and comparable taxes on a business. It would set a universal fair standard for defining nexus and it addresses the question of whether digital commerce, Internet use, the movement of intangible goods and software, and similar activities would create physical presence in a state.

A growing share of home based and other micro businesses are Internet-centric. Although they sell their products and services across the country very few have a physical presence anywhere except their home jurisdiction. They face two nexus related challenges – the trend of state and local governments in other jurisdictions to impose business activity taxes on them based on new "economic nexus" concepts, even though those companies have no physical presence, in the taxing jurisdiction. As a result they are effectively being forced to help underwrite a state infrastructure that they place no burden on and do not receive any benefit from. The second challenge are the efforts of state and local governments to get Congress to pass a Streamlined Sales Tax Initiative that would require Internet vendors to provide state and local sales tax services for the approximately 7,000 state and local taxing authorities. In the latter case, rather than trying to redefine nexus, the states seek an end run around the concept.

Neither businesses nor consumers favor the new "economic nexus" approaches to expanding business activity tax liability or Internet sales tax collection responsibility. In fact, according to a 2008 Parade Magazine survey of 3,125 readers, 85% of consumers oppose taxes on Internet sales. Consumers do not want any state and local sales taxes imposed on their Internet purchases, and they do not want those purchases to be taxed indirectly through the imposition of business activity taxes on their Internet suppliers. It is logical that they would also not want to pay more for products from out of state non-Internet suppliers of goods and services through the imposition of unjustified business access charges. State and local government officials who wish to reflect the will of their constituents should be supporting a permanent sales tax holiday on Internet commerce as well as ways to reduce business taxes on Internet companies.

Restricting the expansion of business activity tax liability and prohibiting state and local governments from imposing sales tax collection responsibilities on businesses outside of their jurisdictions is also sound tax policy. Imposing unjustified new business activity taxes raises the costs of those products to consumers and reduces the international competitiveness of U.S. companies. These taxes also violate the U.S. Constitution by unduly burdening the free flow of interstate commerce.

Encouraging Internet commerce is also sound environmental and economic policy. A drive to the mall generates greenhouse gasses, contributes to traffic congestion, and creates wear and tear on the transportation infrastructure. A consumer who uses Internet commerce to eliminate as little as 1,000 miles annually in driving to stores reduces CO2 emissions by about 1,000 lbs a year and saves about $200 in gas expenses. A click of the mouse therefore reduces the demand for gas, helping to keep gas prices down while also saving state and local governments on transportation infrastructure maintenance costs. The mail carriers and FedEx, UPS or vendors' trucks delivering your orders will be coming down your street anyway, so Internet commerce does not create any additional costs or adverse consequences. Americans work more hours than any other society. Internet commerce also saves consumers a lot of time, a precious commodity for all of us in our society where long working hours leaves too little time for personal relationships and other interests.

For all these reasons AHGA urges all the members of House Judiciary Commercial and Administrative Law Subcommittee to support the Business Activity Tax Simplification Act of 2008, as well as other efforts to encourage the use of Internet commerce.

Prepared Statement of

American Trucking Associations

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

June 24, 2008

Hearing on H.R. 5267

The Business Activity
Tax Simplification Act of 2008

Madam Chairwoman, Ranking Member Cannon, and members of the Committee:

Interstate commerce depends very heavily on efficient freight transportation. Most of that freight is carried by truck – some 68% by tonnage and some 86% as measured by transportation receipts. The interstate motor carrier industry is correspondingly large, comprising several hundred thousand companies. Although some carriers are large, the overwhelming majority of trucking companies are small businesses. The average trucking company operates a fleet of only six trucks, and there are many thousands of operations with only a single vehicle.[1] In many respects, these small businesses resemble their counterparts in other industries, except that even the smallest motor carriers may operate in dozens of states in the regular course of their business.

Our industry faces a serious threat of disproportionate state business taxation, along with the administrative costs and burdens that come with it, from states in which trucking companies do little or no business and with which they have few if any of the connections that are commonly considered to establish tax nexus. The American Trucking Associations appreciates this opportunity to join with other industries to support the call for federal relief from overreaching and inequitable state taxation of interstate commerce.[2] H.R. 5267, the Business Activities Tax Simplification Act of 2008, represents the kind of effort that is necessary. We urge Congress to enact such business tax relief promptly.

Background

Until 1980, interstate motor carriers were subject to strict federal regulation in an economic sense. Prior to deregulation, individual trucking companies did not typically travel in more than a few states and therefore were not exposed to taxation in many states. The great expansion in the number of trucking companies and in the scope of their operations in a largely deregulated economy has changed that. And with deregulation, states began to tap what they saw as a new source of revenue. The fact that trucking companies might be involved in critical areas of interstate commerce seems to have made them more rather than less attractive objects for taxation for states and localities, since, in any given place, most of the trucks passing through do not represent local residents but businesses from outside the state.

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[1] American Trucking Assns., *U.S. Freight Transportation Forecast to 2016*, ATA: Alexandria, VA, 2005, pp. 5-7. Some 89% of motor carriers operate fewer than seven trucks; less than 4% operate more than twenty. American Trucking Assns., *2007-2008 American Trucking Trends*, ATA: Arlington, VA, 2008, p. xiv.

[2] ATA is the national trade association of the American trucking industry. It is a united federation of motor carriers, state trucking associations, and national trucking conferences created to promote and protect the interests of the motor carrier industry. ATA's membership includes more than 2,000 trucking companies and suppliers of motor carrier equipment and services. Directly and indirectly through our affiliated organizations, ATA encompasses over 37,000 companies and every type and class of motor carrier operation.

Prior Congressional Action

Time and again since 1980, Congress has had to step in to protect the motor carrier industry from the effects of state and local taxation, to restrict the taxing authority of these jurisdictions and the manner in which they may administer valid taxes. Some years ago, for example, a number of states began to assess personal income taxes against interstate truck drivers who merely drove through in the course of their employment. Congress responded to this intolerable situation by prohibiting any state but the state of residence from taxing an interstate transportation worker, and from requiring transportation company employers from withholding wages except for the state of residence.[3] Again, following a U.S. Supreme Court decision on a state tax issue that could drastically have affected interstate bus operators, Congress stepped in to give this segment of motor carriers the relief they needed.[4] And in the Motor Carrier Act of 1980 itself, Congress provided the industry protection against discriminatory state and local property taxes and access to federal district courts to invoke that protection.[5]

Because of deregulation and the competition it has so successfully fostered, trucking is today a low-margin industry. Deregulation of our industry has saved the overall American economy billions in reduced transportation costs, but truck rates remain much lower in real terms than they were before 1980.[6] In a typical year, the average for-hire trucking operation may clear a 2% to 3% profit - very roughly, 3 to 6 cents per mile traveled by a truck. In a bad year, the average industry profit may sink close to zero.[7] Compared to many other industries, motor carriers commonly have little in the way of net income for states to subject to tax.

Under economic regulation, except for the largest operations, motor carriers fulfilled their state business tax obligations at home. To a great extent, this has remained the case: small trucking companies, like small businesses in other industries, file corporate tax reports in their state of domicile and in perhaps one or two others where a significant proportion of their business may occur.[8] Indeed, the typical smaller trucking operation has but one place of business – in its home state – and has no property or payroll in any other jurisdiction.[9]

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[3] *See*, 49 U.S.C. 14503.
[4] *See*, 49 U.S.C. 14505.
[5] Congress has granted the railroad industry much more comprehensive protection in this respect, however; compare 49 U.S. 14502(b) with 49 U.S.C. 11501(b).
[6] American Trucking Assns., *2007-2008 American Trucking Trends, op. cit.*, p. 18.
[7] Statistics from 1993 through 2002. American Trucking Assns,, *2004 American Trucking Trends*, ATA: Alexandria, VA, p. 15. The U.S. DOT has yet to release data for more recent years.
[8] All interstate trucking operations, large and small, pay vehicle registration fees and motor fuel taxes for the use of the roads to each state in which they travel. Carriers fulfill these obligations to pay taxes through two organizations – the International Registration Plan and the International Fuel Tax Agreement – that, under Congressional mandate (*see*, 49 U.S.C. 31701, *ff.*), ensure that all states administer these tax programs by means of a uniform structure that all states the revenues due them and minimizes administrative costs for state and motor carrier alike. These operating taxes are not at issue here.
[9] Larger companies, of course, with facilities in multiple states, are obligated to file returns in those states as well as where their home offices are located.

Held for Ransom

Imagine now if you will the situation of a small trucking company, one that might be based in any state and operates only a few trucks. In the course of its business, it gets a call to pick up or to deliver a load in New Jersey, a state it may enter only occasionally. In New Jersey, perhaps at a rest stop or a shipper or consignee's loading dock, an agent of the New Jersey Division of Taxation approaches the truck, identifies himself to the driver, states that the company hasn't registered for the state's corporate tax, and asks the driver how long the company has been picking up or delivering loads in New Jersey. The driver is unlikely to know, of course, but will probably venture some number of years. The state multiplies the number given by $1,100, and the resulting sum serves as a "jeopardy assessment" of corporate tax – in practical effect the ransom for the truck, the driver, and its cargo. The truck and cargo is impounded, the driver is told to contact the company and that the truck will be released only when the money is wired to the state. If the driver protests at the outrage, he may be taken to jail. *There is evidence that New Jersey has held up some 40,000 interstate motor carriers in this fashion over the last five to ten years, extracting many millions of dollars, whether owed or not, from interstate commerce, primarily from small businesses.*[10]

Other State Campaigns

New Jersey is – so far – the only state that has attacked interstate commerce by truck so aggressively. Periodically, however, and typically in bad economic times like the present, one or more states mount a general campaign to force smaller trucking companies located outside their borders but traveling on their roads to pay their business taxes. Such a campaign typically starts with a widespread mailing of a "nexus questionnaire" to hundreds or thousands of motor carriers that have paid operating taxes to the state.[11] Companies that answer the questionnaire and return it – and those that do not return it receive increasingly threatening communications from the state until they do – typically then receive a further letter from the state, advising them that the state has determined that they have nexus there and enclosing a bill, typically for several years (occasionally even decades) of back taxes, plus penalty and interest.

Particularly for smaller motor carriers, this is a cruel absurdity. Typically, the state that seeks to force interstate motor carriers to pay its business taxes not only assesses for years of back taxes, but also either imposes a minimum corporate tax or taxes gross rather

[10] New Jersey does accord a carrier the option of appealing the assessment – once it has been paid – but the process is long, laborious, expensive, and uncertain. Note too that owner-operators that have incorporated, and many have, are also subject to the New Jersey tax, even though they may never operate in the state under their own interstate authority, but always while leased to another carrier. Sometimes, therefore, the presence of a single truck, making a single delivery of freight, is nexus – as far as New Jersey is concerned, that is – for two entities.

[11] When the Pennsylvania Department of Revenue began its "nexus campaign" against the industry about 1993, it mailed out threatening notices and assessments to some 30,000 interstate trucking companies.

than net receipts.[12] Through the use of these gimmicks, a state will have magnified the claimed liability out of all proportion either to the carrier's travel in the state or to its net income.

A large, unanticipated assessment for back taxes frequently represents a disaster for a small (or even a larger) motor carrier. For the more distant back years, the carrier will also be precluded by the statute of limitations from amending the returns it filed with its home state and claiming a credit. Last – and definitely not least – are the accountant's fees the carrier must pay to have the newly required return prepared. These can run upwards of $1,500 for even a relatively simple corporate tax report. And this is an expense the carrier can look forward to bearing into the future, for once it starts filing an annual tax return with a state it cannot easily stop doing so.

State Nexus Standards

What do states commonly assert as tax nexus for an interstate motor carrier? This is often unclear; state tax statutes and regulations often have nothing specific to motor carrier nexus, and provisions adequate for less mobile industries can be perplexing for administrator and carrier alike when applied to trucking. Moreover, while it is undoubtedly the case that a state may under the U.S. Constitution levy a tax on an interstate motor carrier,[13] the U.S. Supreme Court has left this area of the law in obscurity. A state may make a mere assertion of nexus rather than define it exactly. Until recently, no state has sought to collect tax from a motor carrier that merely travels on its roads and has no business at all in the state, but now at least a couple of states seem prepared to try to collect money on even that slim basis.[14]

This uncertainty in the law leaves motor carriers in a quandary, not knowing whether to file in a given state or not. Some carriers file in many more states than is warranted, and spend thousands of dollars annually in accountants' fees to pay perhaps hundreds of dollars in state taxes.[15] Others, in the absence of any indication from a state that out-of-state carriers need to file there, forego filing until suddenly the state changes its position and sends out bills for three, five, seven, or more years of back taxes to thousands of interstate carriers. All of these costs of uncertainty, both administrative costs and the tax liabilities themselves, are passed on, sooner or later, to motor carriers' customers, and are borne by interstate commerce and the Nation's economy in general.

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[12] California, Massachusetts, New Jersey, New York, and Pennsylvania have all aggressively sought to tax interstate motor carriers while they imposed minimum taxes of several hundred to well over $1,000 per year. Michigan and Pennsylvania have sought to impose taxes based at least in part on gross receipts on the industry. Other states that regularly seek to impose their business taxes on interstate motor carriers with only slight contacts with the state include: Illinois, Nebraska, Ohio, Virginia, and Wisconsin.

[13] In fact, the leading case in this area, *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), involved state taxation of a motor carrier.

[14] Nebraska and New Mexico have recently asserted nexus for motor carriers on the basis solely of such "pass-through" miles, no other contact with the state being, in their view, legally necessary.

[15] Filing in many states has another danger for interstate motor carriers: overlapping state apportionment formulas can capture more than all of a carrier's net income for state taxation. *See*, for example, *Consolidated Freightways Corp. of Delaware v. Wisconsin Dept. of Revenue*, 477 N.W.2d 44 (Wisc., 1991).

Conclusion

For the reasons we have outlined, interstate motor carriers are joining with the other industries and approaching Congress for relief from the efforts of states to impose their taxes on interstate businesses that have very tenuous contacts with those states. Public Law 86-272 is of very limited -- if indeed any -- assistance to our industry, and the provisions of that law, which was both necessary and appropriate for its time, urgently need updating to reflect the Nation's deregulated, more mobile, more service-oriented economy. Trucking companies – indeed interstate commerce, to which trucking is so critical – need protection from taxation by a state when they do not have a significant physical establishment within its borders.

Once again, we appreciate this opportunity to testify before this committee.

Robert C. Pitcher
Vice President, State Laws
American Trucking Associations

BIFMA
INTERNATIONAL

The Industry Voice for Workplace Solutions

U.S. House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law
Tuesday 06/24/2008 - 1:00 PM
2237 Rayburn House Office Building

Hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008"

The Business and Institutional Furniture Manufacturers Association (BIFMA) mission is to lead, advocate, inform and develop standards for the North American office and institutional furniture industry. We serve businesses that are primarily engaged in design, development, marketing and fulfillment of office and institutional furniture products.

BIFMA is a not-for-profit organization that serves as a forum for companies to cooperate and collaborate on appropriate industry issues. The issues you are considering today impact us directly. We strongly support H.R. 5267, the Business Activity Tax Simplification Act of 2008 ("BATSA"), and urge that it be reported to the full House for consideration as soon as possible.

This bill would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and comparable taxes on a business. Specifically, the bill would articulate a bright-line physical presence nexus standard that includes owning or leasing any real or tangible property, or assigning one or more employees to perform certain activities in the state for more than fifteen days in a taxable year. In addition, the bill would modernize P.L. 86-272 which prohibits states from assessing net income taxes against a business if its only contact with the state involves the solicitation of orders for tangible personal property.

In the office furniture industry, we like to promote ways that people can "work anywhere". Mobility is a reality and unfair schemes to tax and tax again must stop. This legislation would ensure fairness, minimize costly litigation for both state governments and taxpayers and create the kind of legally certain and stable business environment that this economy direly needs. The bill ensures that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections. It makes common sense.

Sincerely,

Brad Miller,
Director of Communications and Government Affairs
Business and Institutional Furniture Manufacturers Association (BIFMA) International
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General Motors Corporation
Vice Chairman

John J. Castellani
President

Larry D. Burton
Executive Director

Johanna I. Schneider
Executive Director
External Relations

June 20, 2008

The Honorable Linda Sanchez
U.S. House of Representatives
House Committee on the Judiciary
Chair, Subcommittee on Commercial and Administrative Law
Washington, DC 20515

The Honorable Chris Cannon
U.S. House of Representatives
House Committee on the Judiciary
Ranking Member, Subcommittee on Commercial and Administrative Law
Washington, DC 20515

Re: Business Activity Tax Simplification Act (H.R. 5267)

Dear Chairwoman Sanchez and Representative Cannon:

On behalf of the members of Business Roundtable, I am submitting this letter for the record regarding the Business Activity Tax Simplification Act of 2008 ("BATSA"), H.R. 5267, for the Commercial and Administrative Law Subcommittee's June 24, 2008, hearing.

Business Roundtable, a CEO-led organization of leading U.S. companies with a combined workforce of more than 10 million employees and $4.5 trillion in annual revenues, strongly supports BATSA. This important legislation would clarify and modernize the "nexus" rules that govern the ability of States to impose business activity taxes on companies that do not have a significant physical presence in the taxing jurisdiction. The legislation would also update Public Law 86-272 to provide the same protections for sales of services and intangibles that currently apply to sales of tangible personal property. By providing a uniform, national jurisdictional standard for state and local taxation of interstate commerce, BATSA will promote a legally certain and stable business climate that expands interstate commerce. In doing so, this legislation will create new jobs, increase business investment, and foster economic growth.

A 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. It is incongruous with good tax policy that out-of-state businesses, who never set foot in a jurisdiction, should be subject to a tax burden and pay for services in that jurisdiction. In addition, a physical presence standard provides legal certainty, resulting in lower compliance costs and a stable business climate where tax considerations do not hinder business decisions. The physical presence standard is a simple and efficient rule that benefits businesses and state and local governments alike.

With respect to Public Law 86-272, Congress determined that interstate commerce, and the economy as a whole, would benefit if businesses were allowed to solicit customers in a state without being subject to that state's income taxes. BATSA would update these protections to put sellers of goods, services, and intangibles on an even footing. The legislation would also provide clarity and ensure widespread application of Public Law 86-272 by stating that these protections apply equally to all business activity taxes.

By enacting BATSA, Congress will satisfy its constitutional responsibility to ensure that interstate commerce is not burdened by State actions. Importantly, BATSA would not interfere with the ability of a State to impose business activity taxes on a company that is properly subject to its taxing jurisdiction.

Thank you for your consideration of this important legislation.

Sincerely,

John J. Castellani

1303 J Street, Suite 600, Sacramento, CA 95814-2939 T: 916/441-7377 F: 916/441-5756

June 20, 2008

Chairman John Conyers, Jr.
Chairwoman Linda Sanchez
House Judiciary Committee and
Subcommittee on Commercial and Administrative Law
United States House of Representatives
Washington, DC 20515-0539

Re: H.R. 5267, Business Activity Tax Simplification Act of 2008

Dear Chairman Conyers & Chairwoman Sanchez:

On behalf of the California Bankers Association, I am writing to ask that you support H.R. 5267, *The Business Activity Tax Simplification Act*. This legislation expands the federal prohibition against state taxation of interstate commerce to include taxation of out-of-state transactions involving all forms of property, including intangible personal property and services. In addition, H.R. 5267 codifies existing law by reaffirming the rules on state taxation of an out-of-state entity and creates definitive criteria for determining that a person or business has a physical presence in a state.

In 1959, Congress attempted to clarify nexus standards for state and local business activity taxes by enacting P.L.86-272, (15 U.S.C. 381 et seq.). In doing so, Congress established that in order for a business to have nexus in a particular state, it must have a physical presence within that state. In P.L. 86-272, Congress outlined the activities that do not trigger nexus. P.L 86-272 prohibits a state from imposing an income tax on a company whose activities consist only of the solicitation and subsequent sale of tangible personal property delivered outside the state by a common carrier. However, P.L. 86-272 does not define "solicitation" and its application is limited to the net income derived from the sale of tangible personal property. As a result, a patchwork of state laws and regulations has been adopted to independently establish nexus for business activities that are not covered under P.L. 86-272.

In addition, the United States Supreme Court further addressed the matter of nexus in *Quill v. North Dakota* in 1992. The Court held that under the Commerce Clause of the U.S. Constitution, the state of North Dakota could not impose a sales tax on an out-of-state vendor who sold goods to residents but had no physical presence in the state. However, because the term "physical presence" was not well defined by the Supreme Court, states have sought enactment of their own legislation.

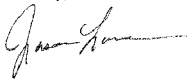
This year, legislation was introduced in the California legislature to redefine nexus to include a "retailer engaged in business in this state" that has substantial nexus with this state for purposes of the

Commerce Clause. Importantly, this legislation eliminated the safe harbor rule that the mere presence of a company's internet server in the state in and of itself will not trigger the obligation to collect California sales and use tax. These independent legislative attempts to redefine nexus, the constitutionality of which will surely be challenged before the courts, lead to costly litigation for states, further depleting them of revenue.

Established more than 115 years ago, the California Bankers Association (CBA) is one of the largest state banking trade associations in the country. CBA leads the way in developing relevant educational and legislative solutions to some of California's more pressing financial and banking issues, including adult financial empowerment, identity theft, financial privacy, and elder financial abuse CBA's membership includes more than 300 of California's commercial, industrial and community banks and savings associations.

On behalf of the California Bankers Association, I ask for your support in passing H.R. 5267. We thank you for your attention to this important matter.

Sincerely,



Jason Lane
VP/Government Relations

June 20, 2008

Statement of Teresa Casazza
President, California Taxpayers' Association
Submitted to the Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

Hearing on H.R. 5267, the Business Activity and Tax Simplification Act of 2008

Madam Chairwoman, Ranking Member Cannon and members of the Committee:

On behalf of the California Taxpayers' Association, I submit this statement in support of H.R. 5267, the Business Activity and Tax Simplification Act of 2008.

The California Taxpayers' Association is a nonpartisan association, founded in 1926 to protect taxpayers from unnecessary taxes and to promote government efficiency. We serve our members through research and advocacy on significant tax and spending issues in the legislative, executive and judicial branches of government. The California Taxpayers' Association is an organization that represents hundreds of small and large businesses that conduct business both in California and nationwide.

Certainty regarding potential tax liability and compliance obligations is essential for business planning and investment decisions. With the growth of electronic commerce, however, and lack of clear guidance from the courts regarding nexus standards for this new avenue of trade, tax obligations with respect to individual states have become confusing and unpredictable.

The lack of certainty with respect to whether a business may be subject to tax in any given state will only get worse with the expansion of Internet sales activity. A uniform "physical presence" standard, which bases the state's ability to tax on the physical presence of the taxpayer in the taxing state, will provide clear guidelines and reduce the costs associated with determining whether a business is subject to tax in any individual state, including litigation costs for taxpayers and state governments.

A uniform "physical presence" standard will allow taxpayers to understand clearly the potential for tax liability in each individual state. Such certainty will allow taxpayers to make informed investment decisions and encourage the expansion of interstate commerce without fear of reprisal from multiple state taxing agencies.

On behalf of the California Taxpayers' Association, I respectfully request your support for H.R. 5267, which will contribute to economic growth and expansion as the economy continues to evolve.

The Computing Technology Industry Association

Testimony Before the

Subcommittee on Commercial and Administrative Law

House Judiciary Committee

"Business Activity Taxes"

Roger J. Cochetti

Group Director-U.S. Public Policy

June 24, 2008

Introduction.

Good afternoon, Chairwoman Sánchez, Ranking Member Cannon, and distinguished members of the Subcommittee. My name is Roger J. Cochetti. I am submitting testimony on behalf of the Computing Technology Industry Association (CompTIA) representing our over 10,000 member companies.

I want to thank Chairwoman Sánchez and Members of this Subcommittee for holding this important hearing concerning the effects of business activity taxes. We are especially concerned about the ramification of some recent developments for small businesses. This is a real issue affecting the economic survival of small businesses, and this issue is in urgent need of an immediate response. We believe your efforts to focus both Congressional and public attention on this issue are most important.

Small businesses are the backbone of the American economy. Some 23 million small businesses employ over half of the private sector workforce. Small businesses are a vital source of the entrepreneurship, creativity, and innovation that keeps our economy globally competitive. As a nation, we are dependent upon the health of the small business sector, and this is why we are concerned with an ever-expanding palate of taxation and tax compliance issues.

CompTIA Overview.

The typical small business does not have an IT department but relies upon the services of an important segment of the computer industry referred to as "Value Added Resellers" or VARs. VARs are small system integrators that design, install, and maintain computer systems and networks for other small businesses. An estimated 32,000 VARs, most of which are small businesses themselves, sell approximately $43 billion dollars worth of computer hardware, software, and services annually. This means that over one third of the computer hardware sold in the United States today is sold by VARs.

Madame Chairwoman and members of the Subcommittee, the Computing Technology Industry Association represents the business interests of these VARs. For 25 years, CompTIA has provided research, networking, and partnering opportunities to its over 10,000 member companies. And while we represent nearly every major computer hardware manufacturer and software publisher, nearly 75% of our membership is comprised of American VARs – the small business component of the tech industry. So, we particularly appreciate the opportunity to provide this testimony to this Subcommittee.

As further background, in addition to representing the interests of VARs, CompTIA also works to provide global policy leadership for the IT industry through our headquarters in Chicago and our public policy offices in Washington, Brussels, Hong Kong, and Sao Paulo. For most people in the computer industry, however, CompTIA is well known for

the non-policy-related services that it provides to advance industry growth: Standards, industry education, business solutions and our very well known professional IT certifications, such as A+.

The Issue.

As states seek to maintain or expand both their tax bases and collections, we note ever-increasing attempts by some state taxing authorities to tax interstate transactions. As established by the U.S. Supreme Court, the principle requirement allowing a state to require a non-resident business to collect and pay over *sales and use* taxes is "*physical nexus*." In Quill Corp. v. North Dakota, 504 U.S. 298 (1992), the Court ruled that a state is not permitted to require a non-resident seller to collect and remit sales and use taxes – unless that seller has a *physical presence* in the state. Therefore, a business that resides in State A cannot be required by State B to collect and remit sales taxes on sales made to customers in State B, *unless that business has a real physical presence in State B*. Commonly, physical presence has been interpreted as having an office or place of business in the state, or employing workers that operate within the state.

One of the basic principles of the *Quill* decision is fairness. That is, it is principally unfair and burdensome for a state to require a business to collect sales and use taxes – when that business has no physical presence in the taxing state. The fairness of *Quill* is

made all the more evident by the fact that most states permit local jurisdictions to impose separate transactions taxes, which can have varying requirements within a single state or jurisdiction. Clearly, for the typical small business, collecting and remitting taxes from states other than their own would impose a massive administrative burden. In addition to monitoring, collecting and remitting sales taxes to multiple jurisdictions, the business would also be burdened with a multiplicity of compliance requirements. So, under the *Quill* decision, the *physical nexus* standard has served to bring both certainty and simplicity to the complicated patchwork of interstate taxation.

However, while the *Quill* decision requires a *physical nexus* in situations involving sales and use taxes, this decision did not specifically address other forms of taxation. Therefore, while *physical nexus* continues to control sales and use tax collections, some states are now seeking to ignore this requirement for other forms of taxation – asserting that an "*economic nexus*" is sufficient. Under this theory, some states have attempted to tax any transaction that has an *economic nexus* to that state. *This is bad tax policy which will result in unmanageable tax and compliance problems for all businesses.*

Imposition of business activity taxes under the *economic nexus* theory imposes a particularly burdensome regime on the IT industry. For example, a VAR located in State A is engaged by a customer in State B to solve a software issue. The VAR has no place of business in State B and has never visited State B. But, without ever entering State B, the VAR connects to the customer's computer via the Internet; the computer is repaired

and the customer is billed for this service. Under the *economic nexus* theory, State B could assert that income earned by the VAR is subject to income and franchise taxes in State B. Also, because the VAR is a resident and is physically present in State A, State A would likewise seek to tax these earnings.

From this example, it is easy to see how adoption of the *economic nexus* will usher in a burdensome and complex new multiplicity of tax regimes for all businesses. This would be most devastating for small businesses which have neither (i) the expertise to learn the taxing requirements of all states, nor (ii) the money to pay a professional to monitor and comply with dozens, hundreds or thousands of taxing authorities.

Recently, one of our VAR members, a small IT business, recounted a situation in which the taxing authority for the state of Maine demanded that this business – which is located in New Hampshire – file a Maine tax return. The Maine tax authority noted that the VAR had a few customers in Maine and that two of the VAR's employees lived in Maine. After substantial time and expense on the part of our small business VAR member, the Maine tax authority eventually withdrew their demand. However, this was only after our member was required to prove that the employees only lived in Maine – and were not stationed there as employees. This CompTIA member company also had to prove to the Maine tax authorities that its business dealings within Maine were *de minimis* and did not warrant a tax return. Of course, we agree with this outcome, but we do not agree with the process that required this small business to spend enormous and needless time, effort, and

expense in order to contest this overreaching approach to interstate taxation. To avoid this in the future, clear and consistent criteria must be established to determine whether a business has a sufficient physical presence in a state to allow that state to impose business activity taxes.

Madame Chairwoman, it now seems apparent that the tax authorities of some states are seeking to exploit a loophole in the Supreme Court's decision in *Quill*. Because *Quill* prohibited the imposition of unfair sales taxes, some states are now seeking to bypass this by imposing unfair transaction taxes. The emphasis must be placed on the term "unfair" – without respect to the type of tax a state seeks to impose on out of state businesses. This loophole needs to be closed before the nation's small businesses suffer any further.

Before any more states move to collect unfair taxes from small out of state businesses, we urge the Congress to require distinct *physical presence requirements* to the taxation of interstate business activities. The emergence of a duplicative and overlapping patchwork of state and local tax filing and payment requirements will seriously damage America's small business community. It would inflict substantial burden and cost on all businesses – with a disproportionate impact on small businesses, especially those engaging in electronic commerce.

Legislation

We call on Congress to pass legislation that will prohibit a state from taxing out-of-state transactions and non-resident businesses *unless that business has an actual physical presence in the taxing state*. We also call on Congress to set forth specific criteria to determine whether a business has a sufficient physical presence to allow taxation. Accordingly, we specifically support the passage of S. 1726, the "*Business Activity Tax Simplification Act of 2007*" and its companion bill, H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

Conclusion.

Increasingly, businesses are being burdened by the both the variety and amount of taxes that must be paid, as well as the costs of compliance. While we fully support the notion that all businesses should pay their rightful share of taxes, we believe this goal can and should be accomplished in the most orderly and least burdensome method. Accordingly, we ask this Subcommittee to support efforts to clarify and simplify the increasing tax and tax compliance burdens for businesses. If not, small businesses – especially small technology businesses – cannot continue to drive the American economy.

We thank this Subcommittee for the opportunity to present this testimony in support of our membership – especially, our over 10,000 member companies, many of which as

small technology companies rely more heavily on income from the remote provision of interstate services.

STATE OF NEW JERSEY
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JON S. CORZINE
GOVERNOR

June 24, 2008

The Honorable Linda Sanchez
Chair
Judiciary Subcommittee on Commercial and Administrative Law
U.S. House of Representatives
2138 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Chris Cannon
Ranking Member
Judiciary Subcommittee on Commercial and Administrative Law
U.S. House of Representatives
2142 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairwoman Sanchez and Ranking Member Cannon:

I write to express my strong opposition to the Business Activity Tax Simplification Act of 2008 (HR 5267). This legislation would trample on the sovereignty of the State of New Jersey, created by our federalist system of government and enshrined in the Tenth Amendment to the U.S. Constitution, and on the plenary power of the states to levy taxes. Additionally, this bill would harm local New Jersey businesses while benefiting large, multi-state or multinational corporations. In the first year alone, this legislation would cost the State of New Jersey $650 million.

Under current statutory, case law and Constitutional law, the State of New Jersey taxes out-of-state companies that do business in the state, based on an economic nexus standard, as well as in-state businesses. Under the "physical presence nexus" standard proposed in HR 5267, Congress would strip New Jersey's authority to tax out-of-state businesses that do not meet this physical presence nexus standard, ignoring the reality that these businesses are actively doing business in New Jersey and benefiting from the use of the state's infrastructure and legal system.

By imposing a national physical presence standard, Congress would unfairly shift the cost of doing business in New Jersey onto local and small businesses, putting mom-and-pop businesses and small, emerging businesses at a distinct disadvantage in competing in the marketplace against the out-of-state business. Many out-of-state businesses would exploit the physical presence nexus standard thereby avoiding their financial responsibilities.

Further, the physical presence nexus standard is a marked retreat from the modern technological and commercial realities of the 21st Century. Today America's economy is grounded in the information age and the sale and provision of services; it is less and less reliant on sectors such as manufacturing. The economic nexus standard fits the current economic realities. The physical presence nexus standard is archaic. It would encourage corporations to manipulate and restructure their business

activities to avoid paying their fair share and provides incentives for businesses to eliminate their physical presence within New Jersey almost entirely.

Recently, the New Jersey Supreme Court has upheld the validity of the economic nexus for taxing out-of-state businesses. (See *Lanco Inc. v. Director, Division of Taxation*, 188 N.J. 380, 980 A.2d 176 (2006), *cert. denied* 127 S.Ct. 2974 (2007).) By declining to consider a challenge to the New Jersey decision, the U. S. Supreme Court strengthened the argument that a state's ability to tax businesses is not limited by a physical presence standard. New Jersey is not alone in taxing out-of-state businesses that meet an economic nexus standard. Courts in Maryland, New Mexico, North Carolina, South Carolina, and West Virginia have also ruled a physical presence is not required for these states to tax out-of-state businesses doing business within the states.

With the economy continuing to weaken and fears of inflation rising, a supermajority of states is suffering. For example, 29 states are projected to face funding shortfalls in the coming state fiscal year. According to a 2006 Congressional Budget Office analysis of similar legislation, 70 percent of the estimated revenue losses would come from ten states: California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington. Four of these ten states rank among the states showing the most economic distress. This legislation is a national fix looking for a problem.

Particularly difficult circumstances confront New Jersey, and we are taking the difficult, and often painful, steps to address our fiscal reality. My state budget for New Jersey's 2009 fiscal year would spend $600 million less that the state spent in fiscal year 2008. This austere budget is achieved by cutting nearly $3 billion in state spending. New Jersey is not able to absorb the economic hardship HR 5267 would create. The initial loss of $650 million in revenue could force unfair increased taxes on local businesses, additional cuts in vital government services for New Jersey's most vulnerable populations, or require federal assistance in the form of state fiscal relief.

Now is not the time to ignore the sovereign rights of the states. Now is not the time for Congress to force changes to settled New Jersey law. Now is not the time for Congress to effectively eliminate $650 million in state revenues in just the first year of implementation of this business activity tax legislation.

I strongly encourage the House Judiciary Subcommittee on Constitutional and Administrative Law, after consideration and discussion during today's hearing, to reject HR 5267.

Sincerely,

JON S. CORZINE

Testimony of the
Council On State Taxation (COST)
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Hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008"

Before the

United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

The Honorable Linda T. Sánchez, Chairman

June 24, 2008

The Council On State Taxation, which is more commonly known as COST, welcomes the opportunity to share with you COST's views on the important issue that you have before you—the appropriate extent of state jurisdiction to tax. 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 more than 600 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.

Our comments address two fundamental questions at issue:

- Why does the issue of Business Activity Tax (BAT) nexus warrant Congressional action?
- Why is physical presence the appropriate standard for BAT nexus?

BAT Nexus Needs Congressional Action

The first, and perhaps most important determination a business must make with regard to State business activity taxes is whether the business is actually subject to tax at all in a particular State. In other words, does the business have "nexus" with the state? This threshhold is governed by the U.S. Constitution's negative Commerce Clause, which prohibits states from unduly burdening interstate commerce. Taxing businesses with only limited links to a jurisdiction has long been considered a burden on interstate commerce because of the high compliance costs associated with the taxation of such fleeting or nominal activity. It is not an exaggeration to note that since the first state business activity tax was imposed, taxpayers have never been certain as to what activities will subject them to the taxing jurisdiction of any particular state or local authority.

The United States Supreme Court has offered some guidance and at least one bright line rule as to the requisite level of activities sufficient to subject a business to a state's tax without creating an impermissible burden on interstate commerce. In its 1992 *Quill* decision, the U.S. Supreme Court reaffirmed an earlier holding from its *Bellas Hess* decision by reiterating its bright line rule that a State cannot impose a sales tax collection liability on a seller that does not have a physical presence in the State. From Congress' perspective, however, *Quill* was additionally a seminal refinement of the Court's earlier jurisprudence, because for the first time it noted a distinction in the concerns underlying the Due Process and Commerce clauses of the Constitution. As part of that distinction, the Court clarified that Congress may legislatively set the jurisdictional standard governing states' ability to impose tax burdens on interstate commerce. Indeed, the Court *invited* Congress to legislate in the area of nexus for state tax purposes, saying: "[O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but one that Congress has the ultimate power to resolve."

In the absence of Congressional action, however, states have become increasingly aggressive in attempting to assert tax jurisdiction over out-of-state businesses. These efforts to reach companies with a minimal or no physical presence in a state have led to litigation in state courts with mixed results—not unexpected given the lack of clear guidance from either the Congress or the U.S. Supreme Court. Conflicting state laws and court decisions create tremendous uncertainty and expense for taxpayers. Multistate businesses are deeply concerned both by this uncertainty and by state efforts to impose tax on businesses that do not have physical presence in a state, thereby burdening interstate commerce and limiting cost effective market options. Surveys of the COST membership consistently demonstrate that this issue is the multistate business community's number one state tax policy concern.

The uncertainty created by conflicting interpretations of the Constitutional standard for tax jurisdiction has long resulted in unnecessary administrative and litigation expense for both taxpayers and states, and will certainly increase the costs and risks of operating a multistate business in the foreseeable future. For example, the recent Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") of its Statement 109 (Accounting for Income Taxes) shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards. FIN 48 appropriately seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes. However, the lack of any national, definitive authority for state tax jurisdiction complicates the analysis under FIN 48 and creates an ongoing dilemma for multistate companies. If a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment often never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence

level ("more likely than not") on the validity of its financial statement reporting position under FIN 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear from its financial statements unless the business is actually audited and the state determines it does not have nexus. This is but one example of how the current uncertainty over the scope of the nexus requirement creates confusion beyond the immediate tax effects.

Congress, accordingly, as the ultimate authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but it also serves as the measure of last resort for the courts and for multistate companies on this issue.

Physical Presence is the Appropriate Standard

It is COST's position, in order for a State or a locality to impose a business activity tax on a business, that a business must have a physical presence in the jurisdiction. Congress must recognize physical presence as the jurisdictional standard for business activity taxes. Physical presence should be defined to include quantitative and qualitative de minimis thresholds. Congress must also prohibit unreasonable attribution of nexus. Finally, Congress must preserve and modernize P.L. 86-272. Legislation currently pending in both the Senate and the House of Representatives would accomplish all of these goals.

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 that businesses that are not physically present in a jurisdiction and are therefore not receiving meaningful benefits or protections from the jurisdiction should not be required to pay tax to that jurisdiction. Such a test also delineates a

clear line to guide both businesses and the states (including their localities) on when a business can be subject to a State's tax.

Congress must exercise its authority under the Commerce Clause of the Constitution to recognize physical presence as the nexus standard for business activity taxes. In doing so, Congress should include de minimis thresholds based on the temporary presence of employees, agents and property in the State. Congress should also modernize P.L. 86-272 by including services and intangibles in its scope, extending its application to all direct taxes, extending its coverage to activities subject to local taxes, and clarifying its definition of independent contractor.

Opponents of a physical presence nexus standard misconstrue both the burdens on business a lower threshold would invite and the global economy in which we now live. In prior testimony before the Senate on state tax jurisdiction, Elizabeth Harchenko, former Chair of the Multistate Tax Commission, argued that "sound economic policy requires the adoption of…economic nexus as the standard for the application of state and local taxes." Nothing could be further from the truth. No tax treaty to which the United States is a party recognizes such a low threshold for tax jurisdiction. What is economic nexus? Is it where a business has a customer? A website? An account receivable? Under an "economic nexus" theory, every company of any measurable size would be taxable in every state. Taken to an international level, every company would be taxable everywhere. Under an "economic nexus" theory, companies would lose any ability they currently have to support states that provide a favorable business tax climate, and states would lose any incentive to provide such an environment.

Indeed, some former tax administrators have recognized the problems inherent in an economic presence nexus standard. A former Multistate Tax Commission Executive Director, Eugene Corrigan, has argued "that the states need to face the reality that most of them are

generally incapable of enforcing the "doing business" [economic presence] 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."

Conclusion

A properly constructed bright-line physical presence nexus standard will promote fairness, eliminate uncertainty for both businesses and states, and significantly reduce the frequency and costs of litigation. We are very interested in working with this Committee and other interested parties to articulate a bright-line physical presence nexus standard that is fair to both business and government.

COALITION FOR RATIONAL AND FAIR TAXATION

June 19, 2008

The Honorable Linda T. Sanchez, Chairman
The Honorable Chris Cannon, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515

Re: Hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008"

Dear Chairman Sanchez and Ranking Member Cannon:

Thank you for the opportunity to submit this statement for the record for the June 24, 2008 hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008," on behalf of the Coalition for Rational and Fair Taxation ("CRAFT"). CRAFT is a diverse coalition of some of America's major corporations involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and multistate entertainment and service businesses. CRAFT members operate throughout the United States, employ hundreds of thousands of American workers and generate billions of dollars for the nation's economy.

CRAFT believes that the bright-line, quantifiable physical presence nexus standard, as provided in H.R. 5267, is the appropriate standard for state and local taxation of out-of-state businesses. Further, CRAFT believes that the modernization of Public Law 86-272, as H.R. 5267 would accomplish, is essential for the health and growth of the American economy. Therefore, CRAFT strongly supports H.R. 5267 and respectfully urges the approval of this legislation for consideration by the full Congress and ultimate enactment. CRAFT believes that it is essential for Congress to provide clear guidance to the states in the area of state taxing jurisdiction, remove the drag that the current climate of uncertainty and unpredictability places on American businesses, and thereby protect American jobs and enhance the American economy.

I. BACKGROUND

The principal motivation for the adoption of the United States Constitution as a replacement to the Articles of Confederation was a desire to establish and ensure the maintenance of a single, integrated, robust American economy. This is reflected in the Commerce Clause, which provides Congress with the authority to safeguard the free flow of

interstate commerce. Enacting legislation regarding states and localities imposing, regulating, or removing tax burdens placed on transactions in interstate commerce is not only within Congress' realm of authority, it is also – we respectfully submit – Congress' responsibility. 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 out-of-state businesses that have little or no connection with their state. Specifically, some state revenue departments have asserted that they can tax a business based merely on its economic presence in the state – such as the presence of customers – based on the recently-minted notion of "economic nexus." 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) and hence, become subject to shareholder lawsuits. 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

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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).

forum.[3] Moreover, the compliance burdens of state business activity taxation can be immense. Think of an interstate business with customers in all 50 states. A recent study found that over 3,000 state and local taxing jurisdictions currently impose some type of business activity tax, and thousands more have the authority to impose such taxes but do not currently do so.[4] 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.

There can be no doubt that the rapid growth of electronic commerce continues to drastically alter the shape of the American and global economies. As businesses adapt to the "new order" of conducting business, efforts by state revenue departments to expand their taxing jurisdiction to cover activities conducted in other jurisdictions constitute a significant burden on the business community's ability to carry on business. Left unchecked, this attempted expansion of the states' taxing power will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation, and uncertainty escalate. Clearly, the time is ripe for Congress to consider when state and local governments should and should not be permitted to require out-of-state businesses to pay business activity taxes. It appears eminently fair and reasonable for Congress to provide relief from unfair and unreasonable impositions of business activity taxes on out-of-state businesses that have little or no physical connection with the state or locality.

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,[5] H.R. 5267 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. 5267 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. 5267 does not apply to other taxes, like personal income

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[3] *See, e.g., Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the House Comm. on Small Business*, 110th Cong. (2008) (testimony of Barry Godwin, on behalf of National Marine Manufacturers Association).

[4] Ernst & Young, *State and Local Jurisdictions Imposing Income, Franchise, and Gross Receipts Taxes on Business* (March 7, 2007).

[5] *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.

taxes,[6] 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.[7]

The underlying principle of this legislation is that only states and localities that provide meaningful benefits and protections to a business – like education, roads, fire and police protection, water, sewers, etc. – should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. Further, businesses should only pay tax to those states and localities where they *earn* their income, and income is only earned where a business is actually located. By imposing a physical presence standard for business activity taxes, H.R. 5267 ensures that the economic burden of state tax impositions is appropriately borne only by those businesses that receive such benefits and protection from the taxing state and ensures that businesses pay these taxes only to those states and localities where they have earned income. H.R. 5267 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. 5267'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.

A. *A Brief History*

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state is a long-standing issue in constitutional jurisprudence.[8] In many ways, the issues before this 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.[9] Prior to that time, there had been a "well-settled rule…that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place."[10] The Supreme Court's 1959 decision in *Northwestern States Portland Cement*, coupled with the Court's refusal to hear two other cases[11] (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-

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[6] In addition, nothing in H.R. 5267 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.

[7] N.M. STAT. § 7-9-1 *et seq.*

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

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

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

[11] *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).

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.[12] 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.[13]

B. *WHERE WE ARE TODAY*

Nearly fifty 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 physical presence in the state whatsoever.[14] This "economic nexus" argument marks a departure from what businesses and other states have believed (and continue to believe) to be the proper jurisdictional standard for state taxation of business activity taxes. Specifically, CRAFT 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.[15] Although this issue has been litigated,

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

[13] 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).

[14] A survey conducted by BNA Tax Analysts demonstrates the extent to which the states are asserting the right to impose tax on out-of-state businesses based on so-called "economic nexus" grounds. *Special Report: 2008 Survey of State Tax Departments*, 15 Multistate Tax. Rep't 4, pp. S-15 - S-53 (April 25, 2008). *See also Ensuring the Equity, Integrity and Viability of Multistate Tax Systems*, Multistate Tax Commission Policy Statement 01-2 (October 17, 2002). *Accord* Letter from Elizabeth Harchenko, Director, Oregon Department of Revenue, to Senator Ron Wyden (July 16, 2001). *See also* Doug Sheppard, *The Certainty of Disagreement on Business Activity Tax Nexus*, 25 State Tax Notes 420 (Aug. 5, 2002).

[15] *The Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary*, 108th Cong. (2004) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair Taxation, Jamie Van Fossen, Chair of Iowa House Ways and Means Committee, and Vernon T. Turner, Smithfield Foods, Inc.); *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*

(continued...)

state courts and tribunals have rendered non-uniform decisions.[16] Unfortunately, the Supreme Court has not granted writs of certiorari in relevant cases.[17]

The bottom line is that businesses should only pay tax where they *earn* income. It may be true that without sales there can be no income. But, while this may make for a nice sound bite, it simply is not relevant. Economists agree that income is earned where an individual or business entity employs its labor and capital, *i.e.*, where he, she or it actually performs work.[18] 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."[19] This is abundantly clear when one considers an individual telecommuter that works from an office in his or her home state, but whose employer is in a different state. Everyone would agree that the telecommuter *earns* income in his or her home state where he or she actually performs business activities, rather than where the employer, which is the customer for the individual's services, is located. Like telecommuters, the location of a business's customers is irrelevant because a business earns its income where it actually engages in business activities – in other words, where it has a physical presence.

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. Proponents of an economic nexus standard also argue that

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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).

[16] *See, e.g., A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 U.S. LEXIS 6033 (2005); *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert denied*, 2007 U.S. LEXIS 7736 (2007); *West Virginia Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert. denied*, 2007 U.S. LEXIS 7868 (2007); *Acme Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72 (Mo. 2002); *Rylander v. Bandag Licensing Corp.*, Tex. App. Ct., No. 03-99-004217-CV (May 11, 2000); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *app. denied* (Tenn. 2000), *cert. denied*, 531 U.S. 927 (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)); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

[17] *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 U.S. LEXIS 6033 (2005); *Comptroller of the Treasury v. SYL, Inc.; Crown Cork & Seal Co. (Del.), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 540 U.S. 9 and 540 U.S. 1090 (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); *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert denied*, 2007 U.S. LEXIS 7736 (2007); *MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert denied*, 2007 U.S. LEXIS 7868 (2007).

[18] 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)).

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

states have spent significant amounts of revenue to maintain an infrastructure for interstate commerce which enables out-of-state businesses to make sales to customers in the state. However, the imposition of a direct tax on an out-of-state business simply cannot be justified on the basis that the state has provided a "viable marketplace" in which to sell goods. It is well accepted that taxes should be, at least in part, payments for benefits or services received from the government;[20] however, the level of benefits and protections provided by a state must be meaningful, not merely incidental or obscure, to warrant the imposition of a direct tax. Businesses only receive meaningful benefits and protections (such as fire and police protection, roads, waters, sewers and education) if they are actually located within a jurisdiction. It is also important to recognize that while a state government may expend resources to maintain an infrastructure for interstate commerce, it does so for the benefit of its constituents – the in-state customers who are presumably already compensating the state for this infrastructure – and not for the benefit of out-of-state sellers. Imposing business activity taxes on out-of-state businesses is truly "taxation without representation."[21]

II. H.R. 5267 PROVIDES AN APPROPRIATE SOLUTION

A. *PROVISIONS OF H.R. 5267*

1. CODIFICATION OF THE PHYSICAL PRESENCE STANDARD

H.R. 5267 provides that a state or locality may not impose business activity taxes on businesses that do not have a "physical presence" (i.e., employees, property or the use of third parties to perform certain activities) within the taxing jurisdiction. In addition, H.R. 5267 provides exceptions for certain quantitatively and qualitatively *de minimis* activities in determining if the requisite physical presence requirement is met.

Quantitatively, a business must have physical presence in a taxing jurisdiction for at least 15 days during a taxable year. This 15-day *de minimis* rule is both appropriate and consistent with the principle that a person should be subject to tax only to the extent that person has received the benefits and protections of a state. The 15-day limitation is measured by each day that a business assigns one or more employees in the state, uses the services of an exclusive agent in the state, or has certain property in the state. Compliance with and administration of this standard would be simple and straightforward.

Qualitatively, H.R. 5267 provides that presence in a state to conduct limited or transient activities will not be considered in determining whether a business has the requisite physical presence in the jurisdiction. This exception is designed to protect activities that are qualitatively *de minimis*.

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

[21] 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.

H.R. 5267 also 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 agent (excluding an employee) to perform services that establish or maintain the taxpayer's market in that state, but only if the agent does not perform business services in the state for any other person during the tax 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. 5267 not only more accurately reflects the economics of a transaction or business, but is also consistent with the current state of the law.[22]

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, H.R. 5267 modernizes the longstanding protections of Public Law 86-272 to include *all* sales and transactions, not just sales of tangible personal property.[23] These provisions update Public Law 86-272 for the 21st century by recognizing the shift in the focus of the global economy from tangible goods to services and intangibles, such as intellectual property.

H.R. 5267 also ensures that Public Law 86-272 covers *all* business activity taxes, not just net income taxes. This provision addresses the efforts of some aggressive states to avoid the restrictions on state taxing jurisdiction imposed by 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 became effective July 1, 2005 and imposes a tax based on gross receipts, and the Texas Margin Tax, effective for tax returns due on or after January 1, 2008, which imposes a tax based on "gross margin" (i.e., total revenues less either cost of goods sold or compensation). What is most distressing about this trend, is that some of these non-income based taxing schemes are specifically designed to circumvent the restrictions Congress intended when it enacted Public Law 86-272. For example, the New Jersey Corporation Business Tax was amended in 2002 to impose a gross profits/gross receipts tax; however, after June 2006, these "gross" taxes 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

[22] 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).

[23] It is important to note that the business activity tax nexus provisions of H.R. 5267 and Public Law 86-272 are two separate constraints on state taxation of interstate commerce and each law operates independently of the other. Thus, any activities protected by Public Law 86-272, as modernized by H.R. 5267, will not create a physical presence for that business, regardless of whether the protected activities occur in the taxing jurisdiction for more than 15 days.

Ohio CAT and Texas Margin Tax indicate that states are increasingly considering enacting non-income-based business activity taxes.[24]

H.R. 5267 also provides that certain qualitatively *de minimis* activities will be treated in the same manner as mere solicitation, and therefore, will be protected by the modernized provisions of Public Law 86-272. Like solicitation, these activities are qualitatively *de minimis* relative to the benefits that protecting such activities offers to the American economy as a whole.[25]

Under H.R. 5267, these protected activities include situations where the business is *patronizing* the local market (*i.e.*, being a customer), rather than *exploiting* that market (many states have issued rulings, albeit inconsistent and *ad hoc* in nature, recognizing this principle). This specifically encompasses business activities directly related to a business's potential or actual purchase of goods or services within the state if the final decision to purchase is made outside the state The principle underlying the protection 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 generating economic activity in the state and 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 would create a disincentive for out-of-state businesses to patronize in-state businesses, thereby negatively impacting the local market and tax revenues.

These protected activities also include mere information gathering. Under H.R. 5267, protected activities specifically include the furnishing of information to customers or affiliates, and the coverage of events or the gathering of other information in the state if the information is used or disseminated from a point outside of the state. The principle underlying the protection of such activities is that the mere furnishing of information is not *market exploitation*, and by protecting these activities, BATSA is protecting the free flow of information in interstate commerce.

B. *COMPARISON TO CURRENT COMMON LAW*

The physical presence nexus standard in H.R. 5267 is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Due Process Clause and the Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus"

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[24] Yet another example is the modified gross receipts tax component of the recently enacted Michigan Business Tax, effective January 1, 2008.

[25] Even the OECD Model Tax Convention, which is a benchmark for the international jurisdictional standards for taxation, recognizes that certain activities should be disregarded. 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").

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.[26] 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?[27]

Since the Supreme Court has not yet ruled on this issue, we must use clear logic and review what state courts and tribunals have recently decided. The answer is clear: if non-*de minimis* physical presence is the test for a mere collection and remission situation such as is the case for sales and use taxes, physical presence must be, at a bare minimum, the appropriate test for the imposition of direct taxes such as business activity taxes. Indeed, the standard for business activity taxes should, if anything, be *higher* than the standard for sales taxes for at least two reasons. First, a business activity tax is an actual direct tax, and not a mere obligation to collect tax from someone else, so if anything, the consequent greater economic burden should require a greater connection with the taxing state (as the Supreme Court *seems* to have recognized).[28] Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes.[29] 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. Several of the state-level decisions on this issue have concluded that there is no

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[26] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[27] 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.

[28] "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)).

[29] *See, e.g.*, *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (U.S. 1977).

principled reason for there to be any lower of a standard for business activity taxes than for sales and use taxes.[30] Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.[31]

III. OTHER CONSIDERATIONS

A. *FEDERALISM*

Contrary to the arguments of some opponents of clarifying the standards for state business activity taxes,[32] considerations of federalism support passing this legislation. A fundamental aspect of American federalism is that Congress has the authority and responsibility to ensure that interstate commerce is not burdened by state actions (including taxation of such commerce).[33] 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.[34] Some critics argue that such

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[30] 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)).

[31] *See* Gupta & Mills, *Does Disconformity In State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, 56 Nat'l Tax J. 355 (June 2003) (discussing the compliance costs associated with state income taxes).

[32] *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.

[33] *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).

[34] A few 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).

measures are too restrictive and violate principles of federalism.[35] 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.[36] Moreover, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[37]

H.R. 5267 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, to determine how to apportion the income that is taxed in the state, to set the rate at which the chosen tax will be imposed, to determine whether or not to follow federal taxable income, to provide credits or deductions for certain types of expenses, and so on. H.R. 5267 merely confirms that the ability of states to tax is subject to constitutional limitations. Thus, H.R. 5267 strikes the correct balance between state autonomy/sovereignty and interstate commerce.

B. *EFFECT ON INTERNATIONAL TAXATION AND AMERICAN COMPETITIVENESS*

Our country's own history and the federal government's position in the context of international taxation provide a strong reason to establish a physical presence nexus standard. Specifically, a physical presence nexus standard would promote consistency between international tax and state tax jurisdictional standards.

For over 80 years, the United States, along with most other countries in the world, has adopted and implemented a so-called "permanent establishment" standard in its income tax treaties with foreign jurisdictions. This "permanent establishment" standard is derived from the Model Tax Convention of the Organisation for Economic Co-operation and Development ("OECD"), which reflects a multinational consensus on the international jurisdictional standards governing taxation.[38] Specifically, the OECD Model Tax Convention aims to limit double taxation, *i.e.*, situations in which a company is taxed both by the country in which the company is domiciled ("resident country") and by a country that is the source of all or part of the

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[35] *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.

[36] *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).

[37] *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.").

[38] Jerome B. Libin & Timothy H. Gillis, *It's a Small World After All: The Intersection of Tax Jurisdiction at International, National, and Subnational Levels*, 38 Ga. L. Rev. 197, 204 (2003).

company's income ("source country").[39] Under the terms of the OECD Model Tax Convention, before a source country may impose a direct tax on a nonresident business' commercial profits, the foreign taxpayer must have a "permanent establishment" in the source country, which is defined generally as a fixed place of business through which the business of an enterprise is wholly or partly carried on.[40] In other words, the OECD Model Tax Convention employs a physical presence jurisdictional standard.[41]

Although this "permanent establishment" standard has been in place for many decades, the OECD was recently charged with revisiting the concept in light of electronic commerce and the changing global economy. After careful consideration, the OECD maintained its firm reliance on physical presence.[42] Not only is H.R. 5267's physical presence nexus standard consistent conceptually with the OECD "permanent establishment" jurisdictional standard, but H.R. 5267's physical presence standard accomplishes the same policy goals by providing a bright-line standard that is clear and equitable.[43] If a more expansive jurisdictional standard is adopted for state tax purposes than that used by the federal government for international tax purposes, it would surely dampen foreign investment in the United States.

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[39] Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, art. 7 (Jan. 28, 2003) ("OECD Model Tax Convention"), n. 1.

[40] OECD Model Tax Convention, Articles 5, 7.

[41] *See* Libin & Gillis, *supra* note 39, at 204.

[42] The 2004 OECD working group approved additional language for the Commentary on the Convention on permanent establishments. The expanded Commentary on permanent establishments reads as follows:

> 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.

[43] Michael F. Mundaca, current Deputy Assistant Secretary for International Tax Affairs in the Treasury Department's Office of Tax Policy, testified before the Senate Committee on Finance as to the effectiveness of this physical presence standard in the international context, and specifically stated that:

> [O]ur experiences in the international tax area, using the well-established PE [(i.e., permanent establishment)] concept, have demonstrated that a clear physical presence standard has created uniformity, predictability, and certainty. It has helped mitigate double taxation and prevent tax jurisdictional disputes. In addition, it has alleviated the administrative burden that would be imposed if taxpayer were forced to file and pay income tax in every jurisdiction in which they have customers or other sources of business income. Multistate taxpayers, likewise, can benefit from a similarly clear consensus standard.

Business Activity Tax Simplification Act of 2005: Hearing on H.R. 1956, "How Much Should Borders Matter? Tax Jurisdiction in the New Economy" Before the Senate Subcommittee on International Trade and Global Competitiveness of the Senate Finance Committee, 109th Cong. (2006) (statement of Michael Mundaca, Partner, Ernst & Young).

Indeed, foreign businesses 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 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.

Further, if states were to decouple from the physical presence standard used for international tax purposes, it could prompt protests or retaliation by foreign governments and/or foreign corporations. Alarmingly, some countries are already 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, citing the efforts of U.S. state revenue departments as support. Indeed, an official in the Treasury Department's Office of Tax Policy, prior to assuming that role, voiced concerns as to the potential international ramifications of assertions of expansive tax jurisdiction by the states.[44] This would be disastrous for the American economy. Enactment of H.R. 5267, which includes a nexus standard that is analogous to that found in U.S. tax treaties, is essential for ensuring that the current international system of taxation remains intact.

IV. RESPONSE TO OPPONENTS OF H.R. 5267

A. *EFFECT ON STATE REVENUES*

There is no basis for the assertion that H.R. 5267 could lead to any meaningful loss of state revenues, much less the large revenue loss that state tax officials and organizations assert.[45] A comprehensive study of the 2005 version of H.R. 5267 projected that the nationwide revenue

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[44] For example, Michael Mundaca, the current Deputy Assistant Secretary for International Tax Affairs in the Treasury Department's Office of Tax Policy has stated that:

> [A]ssertions of expansive tax jurisdiction by the U.S. States could prompt not only protests or retaliation by foreign governments and corporations, but also encourage foreign countries and international organizations to reevaluate the PE [(i.e., permanent establishment)] standard.

Business Activity Tax Simplification Act of 2005: Hearing on H.R. 1956, "How Much Should Borders Matter? Tax Jurisdiction in the New Economy" Before the Senate Subcommittee on International Trade and Global Competitiveness of the Senate Finance Committee, 109th Cong. (2006) (statement of Michael Mundaca).

[45] *See Congressional Budget Office Cost Estimate: H.R. 1956, Business Activity Tax Simplification Act of 2005*, Congressional Budget Office (reported to House Committee on Judiciary on June 28, 2006). *Impact of H.R. 1956 Business Activity Tax Simplification Act of 2005 On States*, National Governor's Association (September 26, 2005); Dolores W. Gregory, *New MTC Chief Names Top State Issues: SSTP, BAT Bills and Federal Tax Reform*, 179 DTR G-8 (2005). *But see Response to the National Governors Association Estimates of the State and Local Tax Impact of H.R. 1956*, Council on State Taxation (Oct. 6, 2005), available at www.statetax.org (addressing the shortcomings in the NGA's estimates of the revenue impact of H.R. 1956).

loss would be 0.8 percent of the total state and local business activity taxes covered by the bill and that the aggregate multi-state revenue loss would be less than one-tenth of one percent of all state and local taxes paid by businesses in 2005.[46] Although a study conducted by the Congressional Budget Office ("CBO") of the 2005 version of H.R. 5267 asserts that revenue losses would be greater than that, the CBO's study has been shown to be flawed in several respects.[47] For example, the study fails to acknowledge that many states will not lose revenue due to passage of H.R. 5267 because many states do not currently impose income taxes on businesses lacking physical presence in the state.[48]

B. *NOT A TAX SHELTER VEHICLE*

H.R. 5267 neither encourages the use of abusive tax planning nor nullifies the ability of states to attack such shelters. Importantly, H.R. 5267 includes a specific provision ensuring that state governments retain all necessary weapons to fight what they perceive as inappropriate tax planning. Therefore, H.R. 5267 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, I.R.C. § 482-type authority to make adjustments to properly reflect income, or similar provisions.

V. CONCLUSION

A physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy[49] and that is consistent with Public Law 86-272, a

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[46] Ernst & Young, *Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections* (July 25, 2006).

[47] *Id.*

[48] Indeed, statements by the former executive director of the Multistate Tax Commission confirm that physical presence is the current standard and, thus, indicates that such estimates of revenue loss are overstated:

> 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).

[49] Professor Richard Pomp, who testified as a tax policy expert on behalf of the taxpayer in *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), articulated "six principles of tax policy . . . as representing the values inherent in the commerce clause: desirability of a clear or "bright-line" test, consistency with settled expectations, reduction of litigation and promotion of interstate investment, non-discriminatory treatment of the service sector, avoidance of multiple taxation, and efficiency of administration." *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 at 15-16 (Oct. 23, 2003). Professor Pomp concluded that a

(continued...)

time-tested and valid Congressional policy. Physical presence is also an accepted standard for determining nexus.[50] And, a physical presence test for nexus is consistent with the established principle that a tax should not be imposed by a state unless that state provides meaningful benefits or protections to the taxpayer. H.R. 5267 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.[51]

Moreover, our country's own history and the federal government's position in the context of international taxation provide sufficient reason to avoid an economic nexus standard. If a foreign country tried to tax the profits of U.S. companies simply because the U.S. firms exported goods to that country, the U.S. government and business community would be outraged. It is precisely for this reason that U.S. income tax treaties provide the nexus concept of "permanent establishment." A physical presence standard places an appropriate limit on states gaining taxation powers over out-of-state firms and conforms to common sense notions of fair play.

What the entire nexus issue boils down to is fairness. The bright-line physical presence nexus standard of H.R. 5267 provides the most fair and equitable standard. This is true primarily because businesses have a reasonable expectation of taxation only when they are the recipients of meaningful benefits and protections provided by the taxing jurisdiction. Additionally, businesses should only pay tax to those jurisdictions where they earn income.

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. 5267 should therefore be enacted. But it is clear that H.R. 5267 warrants the full and enthusiastic support of the Subcommittee. H.R. 5267 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.

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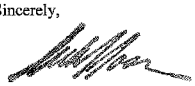
physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.* at 16.

[50] *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).

[51] While it is unrealistic that H.R. 5267 will end all controversies concerning the state tax business activity tax nexus, any statute that adds nationwide clarification obviously reduces the amount of controversy and litigation by narrowing the areas of dispute. For example, in the nearly fifty years since its enactment, Public Law 86-272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense.

Sincerely,



Arthur R. Rosen
Counsel, Coalition for Rational and Fair Taxation

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6/19/08

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June 12, 2008

The Honorable John Conyers, Jr.
House Judiciary Committee
United States House of Representatives
Washington, DC 20515

Dear Chairman Conyers and Members of the Committee:

The Financial Services Roundtable urges you to support H.R. 5267, *the Business Activity Tax Simplification Act* (BATSA). The bill would establish a bright-line physical presence nexus standard for when a state can tax the business activity of out-of-state businesses.

In 1992, the U.S. Supreme Court ruled in Quill Corp. v. North Dakota that a state may not require a non-resident seller to collect sales and use taxes unless that seller has a "physical presence" within the state. One of the governing principles of the Quill decision is fairness. Recently introduced by Representative Rick Boucher (D-VA) and Bob Goodlatte (R-VA), BATSA would not only ensure fairness, but also minimize costly litigation for taxpayers and state governments.

H.R. 5267 would create a stable business environment encouraging businesses to make investments and expand interstate commerce. The legislation would define when companies should be obliged to pay business activity taxes to while preventing the arbitrary state taxation of interstate commerce.

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. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $66.1 trillion in managed assets, $1.1 trillion in revenue, and 2.5 million jobs.

On behalf of the Financial Services Roundtable, I ask for your support in passing H.R. 5267, *the Business Activity Tax Simplification* Act. We thank you for your attention to this important matter.

Best regards,

Steve Bartlett
President and CEO

Letter of Support by Mark B. Wieser
Founder of Fischer & Wieser Specialty Foods, Inc.
For passage of
H. R. 5267, The Business Activity Tax Simplification Act of 2008

Submitted to the United States House of Representatives
House Judiciary Subcommittee on Commercial and Administrative Law

Madam Chairwoman and Members of the Subcommittee, I was requested to submit our experience relating to the assessment of Business Activity Taxes by a state where our company has no physical presence. I also want to express my support for H.R. 5267, the Business Activity Tax Simplification Act of 2008. (BATSA)

I am the founder and chairman of the board of Fischer & Wieser Specialty Foods, Inc. located in the small Texas county of Gillespie, that has produced two outstanding Americans; Fleet Admiral Chester W. Nimitz, Commander-in-Chief of the Pacific Fleet during World War II and President Lyndon B. Johnson.

Our company was founded in 1969 as a roadside market, that I named das Peach Haus, to sell the area's delicious and famous "Fredericksburg Peaches." To supplement my market I had my mother make her home-made jams and jellies to sell and discovered, within a few years, that there was a growing market for home-made quality. In 1986, with a former student, Case D. Fischer, we incorporated the business and began marketing jams, jellies, mustards, salsas, and sauces to the wholesale trade, to up-scale department chains and to gourmet stores under the Fischer & Wieser brand.

To give ourselves exposure we began participating and attending area, state and national shows. In New York City, in 1997, we won the highest award given by the National Association of the Specialty Food Trade (NASFT) for our Original Roasted Raspberry Chipotle Sauce,™ that was and still is the best selling condiment in the United States. We were the first to introduce the chipotle pepper to the American palate.

Today, Fischer & Wieser Specialty Foods, Inc. markets in all fifty states, throughout Mexico and to parts of Canada. We have also exported to Germany and Taiwan on occasions. We sell to all the major national food chains, including Costco, Sams, Kroger, Safeway and a host of regional, up-scale groceries. By 2005 Fischer & Wieser products had captured 2.7% of the national specialty marinade market of companies having more than ten million in annual sales. Today, we employ approximately seventy-five employees and are the largest privately-owned business in our small town. Our weekly payroll injects over forty thousand dollars into our local economy.

Our introduction the Business Activity Tax Nexus issue was sudden and came as a complete surprise. I have to admit, I had never even heard of the issue until, last year, when the company received a letter from the State of Washington asking if we were selling products there. We completed a form which we thought was only a survey asking for a history of sales made to the state and returned it. Given that the company has never had a physical presence in Washington, we were quite shocked when we were assessed more than $15,000.00 in taxes and penalties for the last five years merely for selling to businesses located in that state.

We paid the taxes that were assessed, but appealed the decision and submitted numerous court cases that supported our case to the Washington revenue department. We are still awaiting a decision on our appeal. An attorney, familiar with the state of Washington's interpretation of laws, however, has told us not to expect to win and for us to take the state to court and to hire an attorney would cost more than the amount of money we are asking to be returned.

We based our appeal on PL 86-272 and after reviewing numerous court cases that have dealt with nexus issues. We felt confident that we should not be subject to Washington taxes. To support our appeal we submitted no fewer than three dozen

examples of activities, none of which we performed, that would support the state's claim of nexus.

The only activity performed by Fischer & Wieser Specialty Foods, Inc. in Washington was to send a single representative once annually to call upon a distributor based in the state. In all the cases we cited in our defense this single activity has been shown in case after case not sufficient to confer jurisdiction to assess state tax. The State of Washington's representatives have, however, made it quite clear that in their estimation the sending of a representative into their state is sufficient for them to assert nexus because they claim that we have to send a representative into the state to support the sales or sales would suffer. This is nonsensical and simply not true.

Additionally, Washington has made it quite clear that it considers its tax a Business and Occupation Tax and not a tax covered by PL 86-272. Specifically, the state says that PL 86-272 applies only to states that have enacted a "Net" income tax. Since the state of Washington has a "Gross" income tax their argument is that they are not subject to PL 86-272. This has become a game and one that ordinarily only courts can decide. However, we simply cannot afford to hire attorneys to force the state of Washington abide by the intent of PL 86-272. That is why we so strongly recommend enactment of the current version of BATSA.

Incidentally, in our research we have discovered that the state of Washington is also of the opinion that it has the right to declare Nexus to our company if the driver of the common carrier hired by a Washington state customer does not have the authority from that buyer to inspect and the power to reject products the driver may deem questionable in quality.

The state of Washington has also said that they have the rights to inspect our books and that we are required to keep accurate records of all shipments sent into the state. While we have employed an independent outside audit of our books for more than

a decade we simply cannot afford the additional expense to keep separate books for every state that claims Nexus.

Additionally, our largest customers in the state of Washington is the regional headquarters for the northwestern division of Costco, which acts as regional buyer and sends many pallets directly to its club stores located in the states of Oregon, Idaho, Montana, Alaska and Hawaii without first bringing them into the state of Washington. We have no way of knowing for what areas in that multi-state region Costco has placed our products. Consequently, we very likely paid Washington tax on products that were never actually sent to that state.

Beginning with the first of this year, in an effort to avoid a claim of tax due to Washington for 2008, we have ordered our sales staff not to enter the state of Washington and to make no sales call to entities in that state other than by telephone or email.

All that Fischer & Wieser Specialty Foods, Inc. is asking is for Congress to enact BATSA, a bill that will clearly spell out what will establish state tax Nexus and free small businesses from uncertainty, unnecessary costs and unnecessary individual state regulations.

Fortunately, the state of Washington is the only state that has actively sought to tax us; however, we realistically face similar taxes from all other states if BATSA is not passed. We simply, cannot afford to continue to operate if we are not protected from arbitrary interpretations of tax nexus by the various states.

I can assure you, if Fischer & Wieser Specialty Foods, Inc. had offices or employees in any state, other than Texas and operated there as citizens of that state, or enjoyed the incentives and benefits provided by the legislatures of any other state, or required the assistance of any other state, or advertised offices elsewhere, or did any number of other things necessary to establishing a business in another state, we would willingly and understandingly pay our fair share of taxes due that state. But, for a

business to be subject to income-based tax based on a whim of interpretation is simply not in the best interest of contributing to the economic successes of this nation.

Incidentally, that we are being taxed for doing business with Washington state residents seems very ironic to us as we are the largest consumer of raspberries in the state of Texas and purchase annually many truckloads of raspberries grown by producers in the state of Washington.

Sincerely,

Mark B. Wieser, Chairman
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Testimony of Ivan Petric, Vice-President
Hope Trucking, Inc.
15180 Copeland Way; Spring Hill, FL 34604-8130
Phone: 352-797-4906

IN SUPPORT OF H.R. 5267
On the Nexus Issue of a State's Jurisdiction to Tax
a Business' Activity in Interstate Commerce

Before the
The Honorable Linda T. Sánchez, Chairwoman
United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

June 24, 2008

Madam Chairwoman and members of the Committee. Thank you for the opportunity of allowing me to provide testimony in support of a matter of great importance to the business community the "Business Activity Tax Simplification Act" (BATSA) of 2008. H.R. 5267, introduced by Reps. Rick Boucher (D-VA) and Bob Goodlatte (R-VA), together with a number of additional co-sponsors.

I. Introduction

My name is Ivan Petric, and I am the Vice-President of Hope Trucking, Inc., a small, family-owned and operated company, with annual revenues of approximately $250,000, physically located only in Spring Hill, Florida. We were assessed taxes by the State of New Jersey, Kansas, Arkansas, and others where we have no physical presence, and we want Congress to stop unlawful state attempts to burden interstate commerce by enacting BATSA. Since FY 2004 we've taken very heavy business losses as well as unjust taxation in Interstate Commerce when traveling from state to state when we had no physical presence or nexus[1] with states in other jurisdictions. Ravenous taxation has given too much credence to allegedly "objective" ideas about taxation.

• Why are we testifying

We are speaking up because thousands of small businesses throughout the United States are totally unaware of these potential risks of abuse in the taxation process. Over the past three years we have had conversations with many people across the Country that have shown to us that such abuses are far more common than is generally recognized or reported.

As you know, without strong Federal legislation, all of these small businesses will soon be unable to participate freely in Interstate Commerce without fear of taxation reprisals, regardless of the rhetoric being expounded by some individuals on behalf of the Streamlined Sales Tax Governing Board claiming that states will experience an ever-accelerating loss in their sales tax bases. You cannot lose that which you do not possess. That tax argument is clearly misleading.

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[1] In 1992, the U.S. Supreme Court held in *Quill Corporation v. North Dakota* that the U.S. Constitution requires a bright line physical presence rule for the imposition of a use tax collection. However, many state tax experts and scholars believe that the Quill standard applies to all types of state taxes, not just the use tax.

Subject: Testimony of Ivan Petric in Support of The Business Activity Tax Simplification Act

We urge the Congress' support for a bill that will clarify a reasonable physical presence standard that must be applied when determining nexus for Interstate activity within a state. Our past experience clearly shows what happens when an unclear standard leaves the smallest avenue open to misinterpretation, and an abuse by greedy states that seek taxable revenues and congressional complicity in this effort for the express purpose of expanding the improper jurisdictional reach of state tax systems. This legislation seeks to ensure uniformity versus the crazy quilt of existing state and local sales and use tax laws. This Congress should work together to standardize the administration of these numerous state tax laws.

Today, states face a new threat to the tax revenues they collect. It is they the states themselves. Sadly they have failed to recognize that they have been a key part of the overall problem and refuse to accept the fact that it is their problem to solve without being overly greedy. Many states have been overspending and have placed no self-controls to simplify their aggressive and abusive taxation methods for the 21st Century. The potential abuse of an open checkbook is dramatically clear that these states will continue to overspend and return nothing back to its customers. If there are any, they are a very few of them.

II. Background.

As a small business we incur substantial costs in order to meet our obligations. This expense results in various costly payments in our efforts to comply with state laws, especially in dealing with all of the other states. We find that these numerous state interpretations of the business activity taxes are very difficult and troublesome. I would hope that members of this Committee would question whether forsaking long-standing constitutional standards is the proper response to the greatly exaggerated, and largely self-correcting problem of lost use tax revenue claimed by state tax officials.

Congress clearly knows that taxation without representation is a basic American principle. It is also very clear that this burden falls the heaviest on small businesses that do not have the resources to contest these ill-founded taxes. Congress has a constitutional responsibility to ensure that interstate commerce is not harmed by unfair or burdensome taxation. We commend Congressmen Boucher and Goodlatte for introducing this important legislation, and urge other members to give it their bipartisan support.

Without strong Federal legislation, small businesses will soon be unable to participate freely in Interstate Commerce without fear of taxation reprisals, such as the "centralized, one-stop, multistate registration system that a business may elect to use to register with the Member States." The small business entrepreneur will be like many other citizens, homeless. We are speaking up because thousands of small businesses are totally unaware of the potential risks of abuse in the taxation process. In fact, it is this inherent tension between the insistence of states on maintaining sovereignty, pitted against the desire to expand their taxing jurisdiction that makes the state tax reform competitor, H.R. 3396, fatally flawed and doomed to fail in achieving real simplification and uniformity in state and local sales and use tax systems.

The U.S. Supreme Court and the Congress have decided that the states may not unduly burden companies that have no physical presence in a state with "business activity taxes."

However, many states are being creative in their new legislation and their courts are rubber-stamping the same to bring added taxable revenues to the state's coffers by oversimplifying decisions and stating that because our society has changed so drastically over the past 40 years the framers original thinking was therefore not in conformity with today's taxation woes.

However, of necessity, federalism restricts the ability of a state (or locality) to export its tax system across state borders. To permit each state to visit its unique tax system on businesses that have no nexus with the taxing state would be chaotic on both tax administration and compliance (involving fifty state governments, and more than 7,500 local taxing districts, imposing their vastly different tax regimes on businesses in each of the forty— nine other states). Moreover, out—of—state companies would have no way of influencing the very state tax systems that are newly imposed on them. In the most real sense, allowing the expansion of tax authority beyond state borders is "taxation without representation."

III. The Problem – Bureaucratic Arbitrariness

The U.S. Constitution — and the Commerce Clause in particular — have been the guardians of this nation's open market economy. The central purpose of the Commerce Clause is to prevent states from suppressing the free flow of interstate commerce by the mere imposition of taxes, duties, tariffs, and other levies as it clearly becoming. Indeed, more than two centuries before the establishment of the European Union, the Framers of the United States Constitution created a common market on this continent through the Commerce Clause, and their foresight has powered the greatest economic engine mankind has ever known.

Despite the U.S. Supreme Court's decisions and Congress' efforts to fix this issue many states continue their uncompromising attempts to tax companies by constantly 'twicking' legislation regardless of the lack of physical presence. States have enacted and imposed gross receipts taxes, net worth taxes, and fixed dollar minimum taxes on out of state companies under the theory that P.L. 86-272 bars only imposition of the net income tax. As a result, many businesses are struggling with multi-state tax compliance in the face of very conflicting and confusing guidance. This situation needs to be clarified and BATSA seeks to do just that.

Interstate traffic today is more the rule than the exception, not only for large corporations, but small and medium sized enterprises as well. The current state of confusing and arbitrary taxation of small and large multi-state companies that traverse across state lines only serves to chill interstate commerce. We believe the BATSA language will help to eliminate the current confusion of going after Interstate Commerce traffic and the need for companies to engage in prolonged and costly litigation as one way to improve such tax enforcement discrepancies. BATSA will not diminish the states ability to collect a legally due tax revenue. The pundits tax arguments are clearly misleading. Just as we know that people can sometimes be misled by false prophets.

V. Recent Taxation Nexus Experiences

In the past several years we have experienced several prime examples of arbitrary, capricious, and confusing application of several states tax laws in violation of the Interstate Commerce clause. These examples are not a gross exception or exaggeration. In fact, they illustrate a

Subject: Testimony of Ivan Petric in Support of The Business Activity Tax Simplification Act

larger problem that is faced by small and large businesses across the country.
For example: On June 21, 2005, our company sent a truck and driver to New Jersey to pick up some empty drum barrels for delivery to Baltimore, Maryland. While traveling on an interstate highway in New Jersey our driver, along with numerous other trucking firms, was ambushed at a weighing station in what amounted to a sting operation conducted by the New Jersey Division of Taxation.

The tax collection agent that stopped our truck stated that we had not complied with rule ¶ 902 of the Guidebook to New Jersey Taxes, Corporations Subject to Tax. He further stated that New Jersey had no obligation to provide any notice or legal documentation regarding our non-compliance with New Jersey's tax law, and that it was our responsibility to know New Jersey's legal requirements when traveling within the state.

The agent held our truck and its driver for several hours, and demanded that, in order to release the truck, Hope Trucking had to wire $2,200 in cash immediately to the New Jersey Division of Taxation. The agent claimed that he had the right to hold the truck and its contents indefinitely because we had failed to properly file with the state of New Jersey under its governing guidelines as a foreign corporation. After reading the warrant, which was faxed to us, we found the language to be vague and meaningless.

The "Arbitrary Warrant of Execution" listed the assessment under "Corporation Business Tax, N.J.S.A. 54:10A-1, et.seq.. It showed taxes were owed for years 2004 and 2005 at $1,000.00 per year, for a total of $2,200.00, with interest and penalty. Before our truck could leave New Jersey we were required to "immediately" pay the "taxes due" on the spot or the truck would be impounded to pay for the taxes levied.

I informed the New Jersey agent that his claim was unfounded and explained that we had no ties to New Jersey, and no physical operations in the State. The agent refused to accept this explanation.

Our truck and its driver were finally released after we wired a $2,200 cash payment to the New Jersey Division of Taxation and it was verified as received. We subsequently appealed this aggressive, incorrect, and improper application of the law to the New Jersey State tax director. However, this action was totally ignored. We then appealed the improper taxation to the New Jersey Tax Court. Three years later, we are still before the Tax Court waiting for a Hearing and a refund of the improper taxes we were forced to pay.

We have also faced similar tax assessments in Arkansas, Kansas[2], and New York asserting nexus to the vehicles as property when driven within their jurisdictions.

VI. Conclusion

Our experience is not unique; it is shared by countless businesses, large and small. Many small companies do not have the ability to make an immediate wire transfer of funds much,

[2] K.S.A. 79-6a04 states that a "tax situs" exists for purposes of such valuation, assessment, and taxation, the taxable situs of the over-the-road vehicles and other rolling equipment within the state of Kansas whether owned, used or operated by a motor carrier who is a non-resident of Kansas and irrespective of whether such motor carrier is domiciled in Kansas or otherwise

Subject: Testimony of Ivan Petric in Support of The Business Activity Tax Simplification Act

much less to demand fair treatment from aggressive and abusive states. We believe that BATSA will help clarify the physical presence nexus standard embodied in Public Law 86-272.

Moreover, non-residents of a state are the real victims in Interstate Commerce as they are deprived of the opportunity to exert political pressure upon another state's legislature in order to obtain a change in policy.

It is clearly apparent that the current standards improperly imposed by some states on a simple drive through a state by motor carriers is violative of the Commerce Clause and the Due Process Clause, especially when no nexus to that state or any business enterprises exists. Abandoning constitutional ideals in favor of short-sighted efforts by some avaricious states to increase state tax revenues could undermine America's ideals in this crucial, but still fledgling, economy. The vitality to prosper should not be curbed by federal legislation that saddles small businesses with the burdens of disparate state tax laws whose authority wants to be extended far beyond its traditional jurisdictional borders.

With record high energy prices threatening the nation's overall economy, it is certainly now not the time for Congress to abandon the original intent of the Commerce Clause, but to reinforce it from being abused and mis-interpreted. Moreover, a debate over the wisdom of a federal law to expand state and federal tax jurisdiction cannot be divorced from consideration of the overall impact such legislation would have on the competitiveness of American companies. Not only that, but forcing more new tax collection obligations on small businesses would have the undesirable (and undoubtedly unintended) effect of advantaging their foreign competitors, on whom state and local tax collection obligations could never be effectively imposed.

Congress should be skeptical of arguments that the Commerce Clause is outdated and its restriction on a state's taxing authority is nothing more than a constitutional loophole. We understand that states have a great amount of leeway in the area of taxation. However, this does not mean that there are no boundaries to the permissible area of a state's legislative activity. There are. And none is more certain than the prohibition against attempts on the part of any single state to isolate itself from the difficulties that are common to all of them by restraining the transportation of persons and property across its borders to impose its taxes.

We urge your support and prompt passage of this bill on behalf of the thousands of small business owners nationwide whose economic futures demand clarity for the continued strength and growth of our National economy.

This is sound public policy and we urge its long overdue passage.

Respectfully yours,

Ivan Petric[3]
Veteran, Disabled, Retired

[3] Mr. Petric has a BS Degree in Business Administration. An Honor and Distinguished Military Graduate of the Reserve Officers Training Corps, with numerous Distinguished Service Awards and Letters of Commendation.

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Golden Corral Buffet & Grill

Samuel Wright
FedState Strategic Consulting, Inc.

George Zagnelos
Z Donut Co.

Matthew R. Shay
President and CEO

June 24, 2008

The Honorable Linda Sánchez
U.S. House of Representatives
House Committee on the Judiciary
Chairwoman, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

The Honorable Chris Cannon
U.S. House of Representatives
House Committee on the Judiciary
Ranking Member, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act (H.R. 5267)

Dear Chairwoman Sánchez and Ranking Member Cannon:

The International Franchise Association (IFA) would like to express strong support for the Business Activity Tax Simplification Act ("BATSA") (H.R. 5267). 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 International Franchise Association, the world's oldest and largest organization representing franchising, is the preeminent voice and acknowledged leader for the industry worldwide. Approaching a half-century of service with a growing membership of more than 1,300 franchise systems, 10,000-plus franchisees and more than 500 firms that supply goods and services to the industry, IFA protects, enhances and promotes franchising by advancing the values of integrity, respect, trust, commitment to excellence, honesty and diversity. According to a 2008 study by PricewaterhouseCoopers, there are more than 900,000 franchise establishments in the U.S. that are responsible for creating 21 million American jobs and generating an annual economic output of $2.3 trillion. The great majority of the approximately 2,500 franchisors operating in the U.S. are small businesses, with fewer than 50 franchised outlets.

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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 training advice and guidance, but the duration of such visits normally is limited to a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media. Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on those states.

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.

To illustrate this point Mr. Stephen Joost, Chief Financial Officer of Firehouse Subs, Jacksonville, Florida, testified on February 14 of this year before the House Small Business Committee. According to Mr. Joost, "The way states are imposing burdensome rules, and changing them every year—first it is an unfair tax on intellectual property and secondly it has created a subsidy for lawyers and accountants." Added Mr. Joost, "The fact that I merely step foot in a state creates a taxing event is incredulous."

Illustrating the aggressive and arbitrary nature of state nexus audits on franchise companies, Mr. Joost's own testimony before Congress has been referenced in ongoing

tax disputes with state departments of revenue. For that reason, many members of the IFA are hesitant to share their stories publicly for fear of further retribution. By way of example, the following situation was provided anonymously by an IFA member headquartered in a Western U.S. state:

> *Franchisor Company, Inc. ("FCI") is a franchise company headquartered in State A. FCI files and pay taxes in State A, as this is where they have a material physical presence. They maintain no other offices and their only "physical presence" in other states relates to short training and visits with franchisees in other states. Over the past 5-6 years four regionally varied states have contacted FCI, and as a result of "economic benefit/presence" they have required FCI to file and report in their states. This practice always begins with a self nexus audit.*
>
> *Over the years FCI has spent over $50,000 on accountants, consultants and other costs in reviewing these states' claims of nexus as well as trying to support their objections in light of no material physical presence in these states. FCI has also paid over $100,000 in back amounts to settle with these states for periods prior to their contact with the respective state revenue departments.*
>
> *As a result, FCI has considered eliminating onsite trainings, franchisee meetings, and other support activity that benefits franchisees, truly the core of the concept of franchising. Ultimately, FCI chose to settle as the states offer no due process or appeals process and the costs to litigate this issue against a state is unrealistic for a small franchise company.*

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 small 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:
As you can see from the examples provided, which are indicative of many IFA member companies, the franchising business model is at risk if aggressive nexus audits continue to threaten the ongoing relationship between franchisors and franchisees. While the two are separate entities, the steps necessary to maintain the shared brand do not constitute a presence in every state when that brand appears. The cost associated with compliance and preparation of the returns is a major financial burden for smaller franchisors and in many cases eclipses the taxes being paid.

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, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Thank you for considering this written testimony.

Sincerely,

Matthew R. Shay
President and CEO

June 24, 2008

Chairwoman Linda Sanchez
Ranking Member Chris Cannon
United States House of Representatives
House Committee on the Judiciary
Commercial and Administrative Law Subcommittee
Washington, DC 20515-3804

Re: Support for H.R. 5267
***Business Activity Tax Simplification Act* [BATSA]**

Dear Chairwoman Sanchez and Representative Cannon:

On behalf of the Massachusetts Marine Trades Association and the 27,000 men and women employed by the recreational marine industry in the Commonwealth, I write to urge your support for and co-sponsorship of H.R. 5267, the Business Activity Simplification Act, as means to establishing a bright line of jurisdictional clarity in the imposition of business activity taxes nationwide. Enactment of the bill is necessary to restore order to the states' current "Wild, Wild West" approach in applying nebulous economic nexus standards, resulting in severe economic consequences for Massachusetts businesses.

Business-owning citizens of the Commonwealth have been "held up" by other states and compelled to pay tax assessments based on "economic nexus" theories that are legally shaky at best. Payment of such assessments were based not on acquiescence to the economic nexus standard asserted, but rather on a rational business decision that the cost to fight the tax assessment, including interest, fines and corresponding legal expenses, exceeded the amount assessed. Sadly, there are many Massachusetts business owners who are too scared to speak out on this topic for fear that other states will go after them based on the same renegade economic nexus claims.

The marine industry in Massachusetts is experiencing firsthand the negative effects of the current economic climate. We appreciate that the states have been similarly affected. Nonetheless, it is economically counterproductive for a state to assert vague and unconstitutional nexus standards in an effort to address its economic problems. To do so on the backs of small businesses, which can ill afford the regulatory, compliance or defense costs, is disproportionately unfair. In fact, if businesses are forced to engage accountants and lawyers to investigate, advise or defend against such claims and/or pay such unwarranted tax assessments, their overall profits will decline and the businesses' growth will slow or stop entirely. As corporate profits decline the home states of affected companies – the ones in which they do have a physical presence and which provides them with the benefits of services and protections for which those companies rightfully pay tax will receive less revenue because the overall corporate profit pie has been reduced. The bottom line is that application of overreaching nexus standards by other states on Massachusetts businesses is taking money away from the Commonwealth.

Massachusetts Marine Trades Association
P.O. Box 272 Milton, MA 02186
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Here are some illustrations:

1) The State of Maine imposed a business activity tax on a Boat Builder headquartered outside of and with no physical presence in Maine. Maine asserted that nexus had been established simply and only because the Boat Builder paid a warranty claim to its authorized dealer within the State of. The Authorized Dealer in Maine pays corporate income tax to Maine and collects and remits applicable sales tax on all retail sales of Boat Builder products it sells.

2) The State of Washington imposed business activity tax on a Boat Builder headquartered outside of and with no physical presence in Washington. Washington cited economic nexus due to: a) Membership in a state marine trade association, and b) the Boat Builders' occasional (fewer than 5 days annually) staff visits to the in-state dealer. Because the Boat Builder paid a few hundred dollars to support a state trade association (for boat show exhibition discounts) and periodically sent a sales representative into the state to check on the dealer's product presentation, Washington State found grounds for a tax assessment on the Boat Builder.

3) The State of New Jersey imposed a "jeopardy assessment tax" on a Boat Builder headquartered outside of and with no physical presence in New Jersey and further threatened to impound a truckload of boats passing through its borders en route to Massachusetts if the tax was not paid in full by wire transfer within a few hours. In this case, the goods bound for a Massachusetts dealer and its customers were effectively held hostage while New Jersey sought to determine IF the Boat Builder had any nexus to NJ and what the scope of that activity was. New Jersey asserted that simply having a dealer in that state (to whom the Boat Builder sold wholesale) was sufficient for the state to claim economic nexus to the Boat Builder. New Jersey assessed and demanded immediate payment of $46,200 in back taxes. Held up at the New Jersey border, the Boat Builder had to choose between delaying delivery to a Massachusetts dealer, and expending time and legal fees to object, or paying the "ransom" exacted by New Jersey. Without enough time or money to engage in the argument, and fearing a loss of revenue and customers in Massachusetts, the Boat Builder paid the "toll" and the truckload of product was allowed to proceed to its intended destination in Massachusetts.

4) State Y initially assessed a small Massachusetts business $36,228 for seven years retroactive business activity taxes it reasoned were due simply because the Massachusetts business had an independent agent situated within State Y who represented their product to retailers. After 300 hours of arguing the matter (time that the small business owner could have spent on his business) and payment of $12,000 in legal and advisory fees, the parties agreed to a negotiated settlement.

Utilizing economic nexus standards to generate revenue from out-of-state businesses might seem like a logical solution to the economic problems faced by cash strapped states. However, in addition to running afoul of the U.S. Constitution's Commerce Clause by unduly burdening interstate trade, such approach inevitably will sink smaller businesses and, along with them, a significant engine of the American economy.

Failure to act enact the Business Activity Tax Simplification Act will compound and exacerbate the negative effects already permeating the business community as a result of over-reaching tax authorities including:

- Creating a business climate that is unfair, inconsistent, and unpredictable;
- Increasing business compliance costs which will inevitably be passed on to consumers;

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- Hindering appetite for business expansion due to lack of certainty of tax implication;
- Risking business viability due to burdens of duplicative over-taxation;
- Imperiling continued development of electronic commerce;
- Threatening the revenue collections of states that fully comply with constitutional nexus requirements;
- Thwarting the intent of accounting reporting rules for publicly traded companies;
- Insuring a chilling effect on the national economy by causing tax burdens, compliance costs, litigation and uncertainty to escalate as companies doing business across state lines reassess the value of doing so when measured alongside the costs of doing so in an uncertain, inconsistent regulatory environment.

Your support of H.R. 5267 will not permit businesses with a physical presence in a state to pay one dime less in taxes lawfully assessed or due. Your support will insure that 1) no state may impose business activity tax on any entity that lacks a physical presence in that state, 2) Public Law 86-272 is modernized to better reflect today's commerce by applying equally to the solicitation of sales of intangible goods, and 3) businesses will continue to pay full and fair taxes to those states in which they have a physical presence and which provide the businesses with the benefits and protections afforded to its corporate citizens.

The Massachusetts Marine Trades Association thanks you for holding a hearing to examine this important issue, and request that you quickly follow this hearing with a markup so that it can be reported to the House. We are at your service to provide additional information or to answer any questions you or your staff may have.

Respectfully Submitted,

Kurt Saunders
President

Cc: National Marine Manufacturers Association
Leona S. Roach, MMTA Executive Director

Established in 1964, the MMTA is the statewide, representative body for over 1,200 marine trades businesses in the Commonwealth. Our businesses employ over 27,000 men and women and generate an estimated $1.7 billion in annual economic activity for Massachusetts. The mission of the Association is to further the interests of the marine trades and the boating public through the promotion of boating, participation in legislation and professional improvement programs.

The Association also seeks to stem the exodus of recreational boating businesses from the Commonwealth and the loss of water's edge usage for recreational boating purposes. The Association acts as a source of information about recreational boating and boating businesses for the general public, via its website at www.boatma.com; for the Massachusetts Legislature, where the Association is a frequent participant in public hearings and in the 50-member Legislative Boating Caucus; and for executive branch agencies and authorities with regulatory and economic development responsibilities.

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DAN GLICKMAN
CHAIRMAN
AND
CHIEF EXECUTIVE OFFICER

Monday, June 23, 2008

The Honorable Linda T. Sanchez, Chairman
The Honorable Chris Cannon, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515

Re: Hearing on H.R. 5267, the Business Activity Tax Simplification Act of 2008

Dear Chairman Sanchez and Ranking Member Cannon:

On behalf of the Motion Picture Association of America ("MPAA")[1], I thank you for the opportunity to submit this statement for the record for the June 24, 2008 hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

I. Introduction

The MPAA strongly supports H.R. 5267 and respectfully urges your approval of this legislation for consideration by the full Congress. The MPAA believes that a bright-line physical presence standard is the appropriate jurisdictional standard for state business activity tax purposes. In recent years, an increasing number of states have asserted that a business's mere economic presence in a state is sufficient to subject that out-of-state business to the state's direct business tax. Due to the lack of clear judicial guidance on this issue, states have started taking varying, inconsistent and often aggressive positions with respect to the particular activities that may cause an out-of-state business to become subject to tax. This has created an environment of uncertainty and unpredictability for multistate businesses, especially businesses in the film and media-related industries when such businesses have no physical presence in the state.

This issue is of particular concern to the MPAA because of the aggressive actions taken by states in recent years against film companies, and related entities, such as broadcasters. For

[1] MPAA members companies include Paramount Pictures; Sony Pictures Entertainment Inc.; The Twentieth Century Fox Film Corporation; Universal City Studios LLLP; Walt Disney Studios Motion Pictures; Warner Bros. Entertainment Inc.; and associate member CBS Corporation.

example, states have asserted business activity taxes against film and broadcasting companies claiming "economic nexus" on the following:

- Asserting that an out-of-state broadcaster should be subject to business activity tax in a state solely because the company's broadcast signals are viewed by residents in the state;
- Asserting that the digital transmission of movies to in-state customers creates nexus for an out-of-state film company for business activity tax purposes; and
- Asserting that an out-of-state film company should be subject to business activity tax if the company licenses brands, names, characters or other trademarks to unrelated third parties, who subsequently manufacture and sell merchandise bearing the licensed trademark into the state.

These examples are illustrative and only represent a few of the many state tax jurisdictional issues currently faced by the film and broadcast industry due to inappropriate state actions.

II. H.R. 5267 Provides the Appropriate Solution

Detailed below are some of the more aggressive positions taken by states that are aimed at taxing out-of-state film companies and broadcasters and the arguments advanced by states to support these positions. The MPAA believes that a physical presence nexus standard is the more appropriate jurisdictional standard for state business activity tax purposes. The provisions to modernize Public Law 86-272 contained in H.R. 5267, including the physical presence nexus standard provisions, are both fair and necessary because they are consistent with notions of where income is earned, ensure that businesses are only paying tax to those states that have provided the businesses with meaningful benefits, and represent the application of existing federal law to modern day business transactions.

Broadcast Programming. Some states have asserted that out-of-state broadcasters should be subject to business activity taxes solely because these companies' broadcast signals are received by in-state viewers or listeners. States have tried to justify the taxation of these out-of-state broadcasters on the basis that the out-of-state broadcasters are exploiting the in-state market because the programming is seen and/or heard by individuals in the state. However, this rationale fails to recognize the basic business model employed by most broadcasters. Specifically, broadcasters do not generate revenue from viewers or listeners. Rather, broadcasters receive revenue from advertisers that purchase air time and, in the case of cable programmers, from cable operators that carry the programming. The advertisers and cable operators are essentially the "customers" of the out-of-state broadcaster, not the in-state viewers or listeners who are the customers or potential customers of the advertisers and the cable operators. Thus, broadcasters are not "exploiting" the local market when programming is aired for individual viewers or listeners in a state. Further, broadcasters should only pay tax where

they earn income, and, as discussed in more detail below, income is only earned where a business is physically located.

Remarkably, the states' position is inconsistent with the U.S. federal income tax treatment of foreign broadcasters. In fact, the issue of whether the United States may impose federal income tax on a foreign broadcaster that has no physical presence in this country has been litigated, and federal courts have held that the United States cannot impose such a tax.[2] This holding is reinforced by the "permanent establishment" standard that the United States, along with most other countries, has adopted in its bilateral tax treaties. The permanent establishment standard requires taxpayers to have a fixed place of business (i.e., a physical presence) through which the business of the enterprise is wholly or partly carried on in order for a foreign country to impose an income tax on the business's profits. If states continue to assert positions that contradict these well-established longstanding federal tax principles, it could be potentially disastrous for America's interstate and international economy. On the other hand, the physical presence standard in H.R. 5267 is consistent with the standard used for the U.S. federal income tax treatment of foreign broadcasters, and would only tax out-of-state broadcasters that have a physical presence in the state.

Use of Trademarks in State by Unrelated Third Parties. Several states have attempted to assert taxing jurisdiction over out-of-state film companies that license brands, names, characters or other trademarks to unrelated third parties who then manufacture and sell merchandise bearing the licensed trademarks, for instance, within the state. A recent survey of state tax departments revealed that more than 30 states take the position that the licensing of trademarks to either an affiliated or unrelated entities with a location in the state would create nexus for corporation income tax purposes.[3] These states are overreaching and attempting to tax income that is earned outside of the states' borders.

Film companies do not earn their income in the states where merchandise bearing their trademarks is sold by third parties, rather they earn their income where they actually engage in business activities (i.e., where they have property and employees). The physical presence nexus standard contained in H.R. 5267 would ensure that income is only taxed in those states where the income is earned.

Digital Transmission of Movies. Some states have asserted that out-of-state film companies should be subject to business activity tax if the out-of-state company sells digital films to in-state customers who download the films over the Internet. States assert that they are entitled to tax these out-of-state sellers because the state has provided an in-state market for the digital product. However, state governments maintain a "viable marketplace" for the benefit of their constituents, the in-state customers, and not for the benefit of out-of-state sellers. Further, the imposition of a business activity tax on an out-of-state seller simply cannot be justified on the basis that the government has provided some nebulous and incidental benefit. Rather, the benefits and protections provided by a taxing jurisdiction must be meaningful to warrant the

[2] *See Commissioner of Internal Revenue v. Piedras Negras B. Co.*, 127 F. 2d 260 (5th Cir. 1942).
[3] *Special Report: 2008 Survey of State Tax Departments*, 15 Multistate Tax Rep't 4 at S-28 (April 25, 2008).

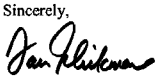
imposition of a business activity tax. Businesses only receive these meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers) in the jurisdictions where they are actually located due to the presence of a labor force or property. Further, as previously discussed, businesses should also only pay tax to those states where income is earned, and income is simply not earned where a business's customers are located. Thus, businesses should only pay tax to those jurisdictions where they are physically present. H.R. 5267 would promote fairness by ensuring that businesses are only taxed by those jurisdictions that have provided meaningful benefits and protections, and in those jurisdictions where income was earned.

In the context of digital downloads, we should also point out some of the peculiar results that can arise if Public Law 86-272 is not modernized for today's economy and modern technologies. For example, if an out-of-state film company conducts in-state solicitation activities aimed to promote the sale of DVDs (i.e., tangible personal property), the orders for which are accepted and shipped or delivered from outside the state, this in-state solicitation would be protected under current law by Public Law 86-272. On the other hand, if an out-of-state film company were to conduct the same in-state solicitation activities to promote digital downloads (i.e., intangible property) for the very same film, these solicitation activities would not be protected by Public Law 86-272. This example clearly demonstrates why the provisions of Public Law 86-272 must be modernized, as provided in H.R. 5267, to protect the solicitation of orders for services and intangible property. Figures released by the Motion Picture Association in May indicate that more than 2.5 billion movie files were downloaded worldwide during 2007. As our economy continues to shift towards intangibles and services, it is important that these sectors of the economy be afforded the important protections of Public Law 86-272.

III. Conclusion

The MPAA believes that it is necessary for Congress to provide clear guidance to the states in the area of state tax jurisdiction and put a stop to the aggressive actions being taken by the states. In the absence of Congressional action, these state actions will likely have a chilling effect on interstate commerce. H.R. 5267 would provide a much needed bright-line physical presence standard that is both fair and reasonable, and would modernize Public Law 86-272 to account for the current state of our economy. As states continue to attempt to maximize revenues, they will likely become even more aggressive in their attempts to tax out-of-state businesses making the need for Congressional action all the more urgent. Therefore, the MPAA strongly urges your approval of H.R. 5267 for consideration by the full Congress.

Sincerely,



Dan Glickman
Chairman and Chief Executive Officer
Motion Picture Association of America

MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

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June 27, 2008

The Honorable Linda Sanchez
U.S. House of Representatives
Washington, DC 20515

The Honorable Chris Cannon
U.S. House of Representatives
Washington, D.C. 20515

Re: H.R. 5267, Business Activity Tax Simplification Act of 2008

Dear Congressmen Sanchez and Cannon,

Thank you for the opportunity to submit these comments on behalf of the Multistate Tax Commission (MTC) into the record of your Subcommittee hearing on H.R. 5267 held on June 24, 2008. It was refreshing to witness the great interest by the Subcommittee members in these issues as well as their sensitivity to the challenges confronting state governments.

It was ironic to read the joint letter from businesses and trade associations supporting uniform standard for state taxation as, just two weeks earlier, nine of those same signatories signed onto a letter sent to the National Conference of Commissioners on Uniform State Laws stating that revising the Uniform Division of Income for Tax Purposes Act to achieve greater uniformity was "neither advisable nor practicable." (*State Tax Notes,* May 28, 2008)

It seemed to be the consensus of the Subcommittee at the hearing that the businesses supporting H.R. 5267 should sit down with the state government representatives and attempt to work out their differences. The MTC stands ready, willing, and able to do just that.

In fact, just three years earlier, business and state government representatives, at the direction of Congressmen Cannon and Watt, met in the very same room as the one where the June 24th hearing was held, to attempt to reach common ground. In 2005, as in 2008, proponents of the Business Activity Tax Simplification Act sought to portray the image at the Subcommittee hearing that the legislation was really an attempt to assist small businesses. Yet, when the state representatives suggested a *de minimis* standard for non-resident corporate taxation, which would have alleviated the concerns expressed by small business representatives, the proponents of the legislation balked, with the representative of the financial services companies stating that such a standard would do nothing for them.

Congressmen Sanchez and Cannon
June 27, 2008
Page Two

It then became clear that the small business rationale was just a smokescreen for the real motives of the legislation's proponents which is to provide substantial tax breaks to large, multistate and multinational corporations **at the expense of small businesses.** Witness testimony at the June 24, 2006 Subcommittee hearing demonstrated that community banks, which could not avail themselves of the benefits of the Business Activity Tax Simplification Act, would be at a competitive tax disadvantage if the bill passed with regard to large, multistate banks with no physical presence in the state but who still offer the same services.

H.R. 5267 represents a blatant and unwarranted intrusion in the authority of states to structure their own tax systems by altering the standard that governs when they may tax companies conducting business within their borders. The changes sought by H.R. 5267 are those that should be left to state elected officials to address.

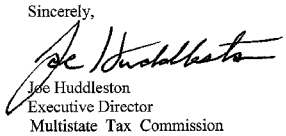
H.R. 5267 promotes avoidance of state taxation. It would subvert state tax systems by creating opportunities to structure corporate affiliates and transactions to avoid paying state taxes. This has been substantiated by the Congressional Research Service.

H.R. 5267 would favor large multistate corporations to the detriment of small businesses and individual taxpayers. It would effectively limit the business activity tax base of states to in-state companies, giving out-of-state vendors an unfair competitive advantage.

Finally, this legislation represents a huge unfunded mandate that will result in the loss of $ 6.6 billion tax dollars to our states. This will leave state legislatures with the unpleasant choice of having to increase taxes on everyone else or to cut needed services. This would be the largest unfunded mandate on the states ever documented by the Congressional Research Service

Thank you for your consideration of this most important issue.

Sincerely,



Joe Huddleston
Executive Director
Multistate Tax Commission

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North American Association of Food Equipment Manufacturers

Statement of David Rolston, President and CEO of Hatco Corporation, on behalf of the North American Association of Food Manufacturers, for the hearing of the House Judiciary Committee Commercial and Administrative Law Subcommittee on H.R. 5267, the "Business Activity Tax Simplification Act", U.S. House of Representatives, June 24, 2008

The Business Activities Tax and its Impact on Small Businesses

Members of the House Judiciary Committee:

Thank you for holding this hearing. In February, I testified before the House Small Business Committee on the impact of state "business activity taxes" on small business. We are pleased that the chair and ranking minority members of that committee subsequently wrote the leaders of the Judiciary Committee asking the Judiciary committee to take up this issue.

Hatco Corporation is a manufacturer of commercial food warming equipment, toasters, and water heaters headquartered in Milwaukee, WI. We have 375 employees, and the company is 100 percent employee-owned.

I also am chair of the Government Relations Committee of the North American Association of Food Equipment Manufacturers. NAFEM represents more than 600 US companies that manufacture commercial food preparation, cooking, storage and table service equipment and supplies used in restaurants, cafeterias, institutional kitchens, and other commercial food service establishments. Typical products are freezers, refrigerators, stoves, ovens and broilers, food warmers, display tables, serving trays, cutlery, and virtually everything you would see in a commercial restaurant kitchen or food service area.

This is a surprisingly large industry. Total domestic sales are over $8 billion -- and it is an industry composed predominantly of small businesses. Sixty-six percent of the members have sales less than $10 million a year with fewer than 100 employees. NAFEM has members from 46 states of the union. Most, like Hatco, are single-state companies, with no physical presence outside their home states.

Efficiency and predictability are essential to a small business. The growing practice of states to assess "business activity" taxes on firms that have no physical presence in the taxing jurisdiction has come as an unpleasant and shocking surprise. If left unchecked, these taxes will become a nightmare for small businesses, increasing our administrative costs, adding an unnecessary layer of inefficiency, and limiting our ability to grow.

Let me give you our example. Hatco, like most NAFEM members, sells through independent manufacturers' representatives who represent 10-15 companies. Hatco also uses independent service agents to complete warranty repairs on our equipment. Again, these independent companies service the equipment of many different manufacturers. Neither of these types of independent companies cause Hatco to have a physical presence outside of Wisconsin. Nonetheless, we are now being forced to pay business activity taxes in four states where we have

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customers but no physical presence. Justification given by the states for these taxes is the existence of the representatives or service agents.

Of course, our manufacturers' representatives and service agents in these states do pay income taxes on their own business profits. That is as it should be. We should be paying taxes in states where we have presence and receive government services. We should not be paying business activity taxes – which are a form of income tax – where we have no physical presence.

We don't know what other states will come at us next. These tax bills catch us by surprise. When states first contact us, they sometimes come on hard. One state originally demanded that we pay eight years of back taxes. This would have been significant. Others have threatened penalties. Litigation, of course, is impractical for a small firm. We try to negotiate, and then we pay up. We can't pass the costs on, so both the tax payments and, even worse, the administrative costs, are off our bottom line.

What are the consequences? Think about where this is going. Facing business activity taxes assessed by four states where we have no presence is bad enough, but 20 states? 30 states? We would have to add staff just to attempt to keep track of these unforeseeable obligations, file the returns, and try to stay clear of penalties and demands for back taxes. These would, of course, be unproductive employees – a hit to our efficiency. And bear in mind that we are a 100 percent employee-owned company. Any added costs hurt every employee.

And what about the overall impact on the economy? The taxes we pay to states where we have no physical presence come off our net profits. So do the administrative costs. As our net income after expenses is reduced, the taxes we owe to Wisconsin and to the federal government also are reduced. After you factor in both the added taxes and the added administrative costs, both to us and to the states, I doubt that anyone is coming out ahead on what the economists would call a macroeconomic level.

Certainly if other states jump on this bandwagon, we will just be spreading the taxes around, with little, if any, net benefit to anyone.

As a small manufacturer in the US, we face many threats from competitors outside our borders. We continue to be successful by staying lean and smart. Adding unnecessary headcount to administer programs like activity taxes makes us less competitive with overseas companies.

For many years, it has been the presumption that businesses pay taxes only in states where they have physical presence and receive government services. We believe the Congress should act to preserve this standard and urge the Judiciary Committee to approve HR 5267, the "Business Activity Tax Simplification Act of 2008.".

STATEMENT OF
THE NATIONAL ASSOCIATION
FOR
THE SPECIALTY FOOD TRADE, INC.

to the
Committee on Administrative and Commercial Law
U.S. House of Representatives

In support of
H.R. 5267, the Business Activity Tax Simplification Act of 2008

June 25, 2008

The National Association for the Specialty Food Trade, Inc. (NASFT) supports H.R. 5267, a bill to regulate certain State taxation of interstate commerce, and for other purposes, popularly called the Business Activity Tax Simplification Act of 2008 or BATSA.

The National Association for the Specialty Food Trade, Inc., based in New York City, is the trade association for all segments of the specialty food industry. Specialty foods are high-value, high-quality, innovative processed foods, such as chocolates, cheeses, snack foods, specialty meats, honey,

cider and other beverages. NASFT has a national membership of approximately 2,800 companies located throughout the United States and overseas. The membership includes manufacturers and processors, brokers, distributors and retailers. Most NASFT members are small businesses. The average specialty food manufacturer does approximately $1, 687,000 in annual sales and, although small, markets 41 SKUs. As small businesses with limited financial resources, few staff and usually no full-time professional advisers (legal and accounting), they are particularly affected by unexpected and unfair taxes imposed outside their home jurisdiction.

H.R. 5267 preserves the ability of NASFT's thousands of small business members to sell their food products using mail solicitations and independent contractors without the threat of unforeseen tax claims by jurisdictions in which they have no – or very limited – physical presence. Several NASFT members have paid thousands of dollars in assessments and back taxes rather than fight claims for the payment of state business activity taxes. Some other NASFT members have spent precious time and resources trying to understand why they were being targeted and how to respond to the claims.

Washington State and New Jersey have been mentioned frequently. For example, NASFT has been told that New Jersey demands a $200 per year registration fee. When it targets a company, New Jersey demands years of back taxes and hefty penalties, even though the manufacturer uses an independent contractor that has business relations with many other small companies) in New Jersey.

Physical presence in a state is a crucial indicator of who should pay business activity taxes. Most small food companies cannot afford a physical presence in states other than their home jurisdiction. When their business grows so that it is reasonable to sell outside the home territory, small food companies often reach out through the mail or through a broker. The broker is an independent contractor - another independent small business – who sells several product lines. In fact, the brokers are larger and more profitable than the food manufacturers and, consequently, can be expected to pay more taxes. According to NASFT's *The State of the Specialty Food Industry 2008*, the median annual sales of a specialty food manufacturer is $1,687,000, while the median annual sales of a broker is $4,862,000. Of course it must

be understood that most specialty food companies are well below $1 million in annual sales – they are very small businesses.

If the food manufacturer is successful, it pays income taxes to its state authorities. The success of the manufacturer means that the broker earns commissions, on which it pays taxes to the broker's state authorities.

NASFT does not offer this information to argue for higher or new taxes on brokers. Good brokers are essential to the success of specialty food manufacturers. Rather, the information is offered to show that states are receiving tax income from their own citizens – those who are using and benefiting from the local government services.

Given the worsening fiscal situation of many states, state tax authorities may be tempted to use an economic presence standard to capture tax revenue from out of state companies. Speedy action by the House of Representatives is needed to avoid these "grabs". While the situation of local jurisdictions might be deteriorating, small businesses are feeling greater financial pressures. An unfair and unwarranted tax claim would be devastating for many small companies at any time but particularly during the current economic downturn.

NASFT members understand that they must pay certain taxes, like their income taxes and social security taxes. They understand that the taxes support the services provided by their local government and the federal government. They expect businesses in other jurisdictions to support their local governments, because those businesses are the ones that receive the fire and police protection, use the public schools and the roads, exercise the right to vote there and enjoy activities like "Summer in the Park". The later state should not reach over into another jurisdiction to claim tax revenue from businesses without a physical presence, since its citizen is paying for the services associated with the sales.

A physical presence standard is the only reasonable nexus test for small businesses. An economic nexus test would be so costly that many successful small food companies would forego their right to conduct interstate commerce in some states in order to avoid the possibility of unfair tax assessments.

For the above reasons, NASFT urges passage of H.R. 5267.

Statement of
Jerald Otchis
Vice President Finance and Administration
Bobrick Washroom Equipment, Inc.
North Hollywood, CA

On Behalf of the
National Association of Manufacturers

Before the
House Judiciary Subcommittee on Commercial and Administrative Law
U.S. House of Representatives

Hearing on
H.R. 5267, Business Activity Tax Simplification Act of 2008

June 24, 2008

Ms. Chairwoman and Members of the Subcommittee,

I am pleased to have the opportunity to submit this statement on behalf of the National Association of Manufacturers (NAM) for the record of the June 24, 2008, House Judiciary Subcommittee on Commercial and Administrative Law hearing on the impact of business activity taxes (BATs) and H.R. 5267, the Business Activity Tax Simplification Act of 2008.

The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. My name is Jerald Otchis and I serve as Vice President Finance and Administration at Bobrick Washroom Equipment, Inc. Bobrick, a member of the NAM, is the leading company in the world in the design, manufacture and distribution of washroom accessories and toilet partitions for the non-residential construction market. The company celebrated its 100th anniversary in 2006.

The Business Activity Tax Simplification Act

NAM members strongly support bipartisan legislation H.R. 5267, the Business Activity Tax Simplification Act (BATSA) introduced earlier this year by House Judiciary Committee members Rick Boucher (D-VA) and Bob Goodlatte (R-VA). By establishing a bright-line physical presence test for when a state can tax out-of-state companies, BATSA will prevent the arbitrary state taxation of interstate commerce without jeopardizing the ability of states to legitimately tax companies with operations in the state.

Some states currently assess business activity taxes (BAT), e.g. income, franchise, or gross receipts taxes, on out-of-state manufacturers and other businesses that do not have any employees or property in the state. This arbitrary taxation of out-of-state businesses interferes with interstate commerce. Lawmakers last addressed this issue in 1959, when they clarified that a state cannot impose income taxes on an out-of-state company if the company's only contact with the state is to solicit orders for sales of tangible goods. BATSA would update the current "safe harbor" for soliciting sales of tangible goods to sales of intangible goods and services.

One Company's Experience

Bobrick's headquarters, including manufacturing and distribution facilities, are located in North Hollywood, California. In addition, Bobrick has factories and warehouses in Colorado, New York, Oklahoma, Tennessee, and Toronto, Canada. The company, which employs more than 500 people, has subsidiaries in Australia and England. Bobrick manufactures more than 70 percent of its products in the United States and exports more than $25,000,000 of U.S.-made products each year.

Our products are sold in all fifty states to independent distributors who generally act as installing subcontractors to the general contractor constructing the building. All orders for product are sent to a Bobrick facility and shipped using common carriers.

Bobrick does not contest our responsibility to pay business activity and other taxes in the five states where we have facilities—California, Colorado, New York, Oklahoma, Tennessee. At the same time, the company has experienced first-hand attempts to impose business activity taxes on Bobrick by states where we do not deliver with company trucks, install or repair our products or have employees, offices, repair facilities, or bank accounts. Our efforts to fight these unfair assessments have consumed an enormous amount of time and valuable company financial resources, company dollars that could have been better spent on business expansion, job creation, and innovation.

In the 26 years I have been employed by Bobrick, we have had requests from more than ten states asking us to complete a questionnaire, consisting of fifteen to forty questions, to determine whether we have sufficient physical presence to constitute nexus with the state and thus be subject to the state's business activity taxes.

There is no single litmus question for determining nexus for purposes of imposing business activity taxes on out-of-state businesses, but rather the nexus decision should be based on a preponderance of facts and circumstances. In my experience, Bobrick generally has been able to answer most questions about presence in the negative and there have been no further inquiries from the state.

Occasionally, however, a question is phrased in such a way that a "no" answer is not appropriate. For example, the compound question by the state of Texas is worded to include employees, agents, or representatives who sell, solicit, or promote products in the state. Because

of the way the question is worded, the state inevitably asserts nexus, which is what happened in our case. We currently are appealing the Texas decision on nexus, an effort that already has cost us well over $100,000 for attorneys and consultants as well as a significant amount of internal staff time.

Furthermore, based on Bobrick's experience and the experience of other NAM members, this arbitrary and discriminatory state taxation falls disproportionately on small and medium size companies.

When my company was first challenged by the state of Texas, we asked other small and medium size companies that are members of the NAM about their experiences. Several NAM member companies also had been contacted by the state of Texas. While they felt they were not subject to Texas business activity taxes, the amount of taxes involved was small in comparison to the cost of challenging Texas' position, making it less costly for the company to pay the taxes. As a result, while it is likely that states may not win on imposing business activity taxes if challenged, most companies can not justify the cost of a challenge. This situation is blatantly unfair and particularly burdensome for small and medium size companies that do not have in-house legal departments to fight such arbitrary state taxation.

Furthermore, with more and more states taking an aggressive stance in imposing arbitrary business activity taxes on out-of-state companies, this additional taxation increases the domestic effective tax rates for U.S.-based companies, making it harder for these companies to compete globally.

Summary

The NAM strongly supports enactment of BATSA, which would establish a bright-line, physical presence test to determine when a state can levy income, franchise, gross receipts and other business activity taxes on out-of-state companies engaged in interstate commerce. By updating current law, BATSA would prevent a state from imposing business activity taxes on an out-of-state company if the company's only contact with the state is to solicit sales of tangible and intangible goods and services. Companies without a physical presence in a state would not be subject to business activity taxes simply because they have worldwide customers.

The legislation also would clarify that a state should not impose a business activity tax unless that state provides benefits or protections to the taxpayer. At the same time, it would reduce widespread litigation associated with the current climate of uncertainty that inhibits business expansion and innovation. Businesses of all sizes need the certainty of a "uniform state taxation nexus standard;" i.e. the minimum amount of activity a business must conduct in a particular state before it becomes subject to taxation in that state.

Thank you in advance for supporting this important legislation. Bobrick, as well as companies of all sizes—particularly small manufacturers—would benefit from the clarity and certainty provided by this important legislation.

Supplemental Sheet

House Judiciary Subcommittee Hearing on Business Activity Taxes
6-24-08

Statement by:

Jerald Otchis
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On Behalf of:

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Comments of the National Foreign Trade Council
On the Business Activity Simplification Act (H.R. 5267)
Before the House Judiciary Commercial and Administrative Law Subcommittee
On June 24, 2008

The National Foreign Trade Council (NFTC), organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and the NFTC therefore seeks to foster an environment in which U.S. businesses can be dynamic and effective competitors in the domestic and international business arena. The NFTC strongly supports H.R. 5267, the Business Activity Tax Simplification Act, ("BATSA"), and respectfully asks that you support the bill and schedule it for a markup.

H.R. 5267, a bill introduced recently by Representatives Rick Boucher (D-VA) and Bob Goodlatte (R-VA) with strong bipartisan support among members of the Judiciary Committee, would clarify the constitutional 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 articulates a bright-line physical presence standard that would ensure that both states and businesses understand the tax rules under which they are operating, which is particularly important for businesses with customers in many states that all have separate business tax regimes and standards

The NFTC has a particular interest in supporting the BATSA bill, as the state's actions in pursuing taxes where there is a lack of physical presence of the taxpayer has and will cause uncertainty and widespread litigation, so much so that it has and will create a chilling effect on not only inter-state but also international commerce. The physical presence standard is articulated as a "permanent establishment standard" in our bi-lateral tax treaties and under OECD guidelines. In other words, physical presence is the international norm. Adoption of a more nebulous standard by the States undermines these international treaties. Moreover, a violation of the international norms by the imposition of business activity taxes undermines the United States' negotiating position with foreign nations. A new tax structure is likely to invite reciprocal, aggressive tactics by foreign taxing authorities, seriously compromising the competitive leadership of U.S. businesses. Under the foreign tax credit system that has long been a cornerstone of our income tax system, this would in effect force the United States to cede to other nations' tax jurisdiction over U.S. activities that have no physical presence abroad.

BATSA would ensure fairness, minimize costly litigation and create the kind of legally certain and stable environment that encourages businesses to make investments, expand interstate commerce and create new jobs. At the same time, the bill would ensure that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections.

Thank you 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.

June 20, 2008

Statement of Kristina Rasmussen
Director of Government Affairs for the National Taxpayers Union
Submitted to the Subcommittee on Commercial and Administrative Law
United States House of Representatives
On H.R. 5267, the Business Activity Tax Simplification Act

Dear Ms. Chairwoman, Mr. Ranking Member, and Members of the Subcommittee:

On behalf of the 362,000 members of the National Taxpayers Union, I urge you to support H.R. 5267, the Business Activity Tax Simplification Act. This legislation is an important element of broader tax simplification efforts. Specifically, the bill establishes a clear test to ensure that only businesses having employees or property physically present within a given jurisdiction are subject to business activity taxes.

The integration of the Internet and telecommunication technologies has allowed businesses to expand across state lines, to the point where such activities are commonplace. However, these developments have created confusion about when states are allowed to collect income taxes from out-of-state companies conducting certain activities within their respective jurisdictions.

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. At that time, the Supreme Court declined to rule on the nexus standard as applied to business activity taxes. Unfortunately, governments are increasingly defining "substantial nexus" differently, leading to a complex matrix of tax rules. If this practice continues, it will have a grim effect on interstate commerce and the entire economy.

In 2007, the Court refused to review two cases that would have directly challenged the constitutionality of extreme applications of "economic nexus" standards. Thus, a legislative solution is clearly warranted. Congress now has the opportunity to resolve this ongoing dispute by approving the pro-taxpayer approach contained within H.R. 5267.

The Business Activity Tax Simplification Act protects taxpayers from harmful state policies by providing standards that define when firms are obliged to pay business activity taxes. The legislation promotes fairness, minimizes litigation, and creates a business climate that encourages companies to invest and to expand interstate commerce. This legislation is a common-sense way for Congress to promote economic growth, and we urge all Members to support H.R. 5267.

Sincerely,

Kristina Rasmussen

Kristina Rasmussen
Director of Government Affairs

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STATEMENT OF THE NEW YORK BANKERS ASSOCIATION

BEFORE THE HOUSE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

COMMITTEE ON THE JUDICIARY

ON H.R. 5267, THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2008

JUNE 24, 2008

The New York Bankers Association appreciates the opportunity to submit this statement for the record of the hearing of the Judiciary Committee's Subcommittee on Commercial and Administrative Law on H.R. 5267, the Business Activity Tax Simplification Act of 2008. The New York Bankers Association strongly supports this legislation that would clarify and modernize the rules governing a state's ability to impose income taxes on companies that have no physical presence in the state. Our Association is comprised of the community, regional and money center commercial banks and savings institutions doing business in the State of New York. Our members hold aggregate assets in excess of $9 trillion and employ more than 300,000 New Yorkers.

This legislation will clarify that states may not tax out-of-state intangible property or services. Current law clearly precludes state taxation of out-of-state tangible personal property and real estate. The bill will also require that an entity have a physical presence in a state in order to subject the entity to the state's taxing jurisdiction. The bill sets forth criteria for determining whether a physical presence exists.

This legislation will clarify situations in which a state can constitutionally tax out-of-state corporations. It is particularly important for a State like New York that sells vast amounts of financial services in other states. The physical presence standard contained in the bill is one that the United States Supreme Court has recognized as an appropriate nexus for state taxation.

In recent years, an increasing number of states have enacted legislation taxing business activities that occur outside their physical jurisdiction and that bear only a remote relationship to the taxing states. In the financial services arena, these enactments have largely focused on taxing loan and investment relationships entered into by residents of the taxing states with non-resident business entities whose only relationship with the taxing state is the use of instruments of interstate commerce, such as the Internet, the United States Postal Service and the telephone to transact business with their customers. These states have been characterized as "market states," because they attempt to tax the market for goods and services, rather than the physical entity that provides the goods or services.

This system of taxation is clearly a burden on interstate commerce and falls squarely within the jurisdiction of Congress to address. The home states of companies being taxed by market states already tax the profits of these companies, resulting either in double taxation or in a reduction in revenue for home states. With the increased reliance by customers on the Internet, the taxation of out-of-state residents and businesses will clearly become a more and more attractive means to enhance a state's revenue. It can therefore be expected that, without Congressional oversight, attempts to tax companies without a physical presence in a state will continue to increase.

H.R. 5267 draws a clear distinction between allowable and impermissible taxation by a state of the intangible activities of out-of-state residents and businesses. We strongly urge that the legislation be enacted.

State of New Jersey
DEPARTMENT OF THE TREASURY
DIVISION OF TAXATION
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June 18, 2008

The Honorable Linda Sanchez, Chair
Commercial and Administrative Law Subcommittee
House Committee on the Judiciary
H2-362 Ford HOB
Washington, D.C. 20510

The Honorable Chris Cannon, Ranking Member
Commercial and Administrative Law Subcommittee
House Committee on the Judiciary
B-351 Rayburn HOB
Washington, D.C. 20510

Dear Congresswoman Sanchez and Congressman Cannon:

Please accept this letter as part of the record of a June 24, 2008 scheduled hearing on H.R. 5267. This submission by the State of New Jersey is intended to provide the members of the subcommittee with an accurate explanation of a tax enforcement program that has been unfairly portrayed by some members of the public and the press.

The New Jersey Division of Taxation has a variety of legislatively created enforcement tools available for use in administering the State's tax laws. Both the tools and the laws are intended to ensure that everyone pays their fair share of taxes and, as they apply to business taxpayers, every business competes in the economy on a level playing field. One of those tools, the jeopardy assessment, has unfortunately become an easy target for individuals who find publicity value in stereotyping tax enforcement efforts as draconian, mean-spirited and anti-business. In administering tax laws fairly and impartially, the Division of Taxation occasionally encounters such distortions and welcomes the opportunity to debunk the myths and provide factual information in context. Of course, rules governing the confidentiality of tax data in the records of the Division of Taxation prohibit disclosure by the Division of facts relating to the tax accounts of any specific taxpayers.

The Division of Taxation put into practice a jeopardy assessment initiative in 1996 in response to a problem that was placing local businesses at an economic disadvantage and simultaneously depriving the State of tax revenue to which it was entitled. New Jersey is a wealthy State with the second highest per capita income in the United States. Because of the wealth of its residents, New Jersey maintains a diverse

and robust consumer sector. Our State enjoys a unique geographic location with a first-class interstate transportation system making New Jersey easily accessible from points north, south and west. Over 100 million consumers with a collective purchasing power of $2 trillion are within a 24-hour drive. The State has 35,000 miles of roads that help move goods efficiently to their destinations. Our location on the Atlantic Ocean has produced port activities that have fostered a strong logistics and warehousing sector. The Port of New York and New Jersey is the largest port complex on the Eastern Seaboard and the third-largest U.S. port complex. It is the source of 230,000 jobs and is responsible for more than $100 billion in trade. These attributes of wealth and accessibility make New Jersey an attractive location to transient vendors seeking to exploit our economic market. It is easy for out of state vendors to enter the State, sell their goods and depart in quick order. Though they take advantage of our transportation system so as to access our vibrant consumer markets, many of these transient vendors decline or refuse to register their businesses in New Jersey thereby sidestepping their tax responsibilities. By their defiance, these businesses gain a tremendous economic advantage at the expense of both local businesses and the public fisc.

By the early 1990's New Jersey businesses, such as the furniture retailers were complaining of their competitive disadvantage vis-à-vis transient vendors that derived income from their exploitation of local markets, undercut local businesses, and evaded their tax obligations. The Division of Taxation recognized that allowing non-compliant transient vendors to continue to operate was a serious challenge to the Division's mission to fairly, impartially and equitably administer the tax laws. Lack of attention to this problem would perpetuate the underground cash economy and continue the inequities faced by the bricks and mortar New Jersey establishments. The jeopardy assessment program was constructed to respond to the situation. While the program initially was conceived to stop the tax abuse associated with transient vendors, its implementation is not limited to out of state vendors; it encompasses in-state vendors with tax compliance issues.

The underpinnings of the jeopardy assessment program are legislative, having been enacted in 1936. N.J.S.A. 54:49-5 and 49-7 authorize non-traditional tax compliance initiatives under certain circumstances.

N.J.S.A. 54:49-5 authorizes arbitrary tax assessments:

> If any taxpayer shall fail to make any report as required by any state tax law, the commissioner may make an estimate of the taxable liability of such taxpayer, from any information he may obtain, and according to such estimate so made by him, assess the taxes, fees, penalties and interest due the state from such taxpayer, give notice of such assessment to the taxpayer, and make demand upon him for payment.

N.J.S.A. 54:49-7 provides:

> If the commissioner finds that a taxpayer designs quickly to depart from this state or to remove therefrom his property, or any property subject to any state tax, or to conceal himself or his property, or such other property, or to discontinue business, or to do any other act tending to prejudice or render wholly or partly

> ineffectual proceedings to assess or collect such tax, whereby it becomes important that such proceedings be brought without delay, the commissioner may immediately make an arbitrary assessment as hereinbefore provided in section 54:49-5 of this title whether or not any report is then due by law, and may proceed under such arbitrary assessment to collect the tax, or compel security for the same, and thereafter shall cause notice of such finding to be given to such taxpayer, together with a demand for an immediate report and immediate payment of such tax.

The statutes afford the Division of Taxation the right to exercise extraordinary enforcement measures when the circumstances demonstrate a credible risk that the New Jersey tax laws are being ignored, thus placing the collection of state revenue at risk.

Division personnel follow a well-established protocol that neither exceeds the permissible boundaries of the law nor ignores the rights of taxpayers when determining if circumstances warrant the issuance of a jeopardy assessment. Division field investigators work in conjunction with State Police at vehicle weigh stations and with Motor Vehicle Commission mobile inspection teams. State Police and MVC inspectors conduct their normal operations without interference by Taxation personnel. After identifying a vehicle of a business that may be subject to New Jersey taxes, an investigator will request the officer to direct the vehicle driver to Taxation personnel. The investigator interviews the driver to gather information on the company's activity in New Jersey, such as:

- how frequently the company comes into New Jersey;
- whether the driver collects past due accounts;
- provides installation after delivery;
- picks up or replaces damaged goods;
- provides technical assistance;
- stocks products or conducts inventory; or
- performs repair or maintenance services.

In addition, the investigator examines the driver's delivery invoices for corroboration of the proffered information.

The investigator then remotely accesses Division records to ascertain whether the business is registered and/or in tax compliance. If the business is not in compliance with New Jersey tax laws, the investigator informs the driver of the findings and requests the driver contact company headquarters. The investigator explains the findings to the company representative, giving him/her opportunity to demonstrate compliance. At this point in the process, the investigator is able to weigh all the available information and make a determination as to whether a jeopardy situation exists and whether a jeopardy assessment should issue.

The evidence is carefully evaluated on a case by case basis. A jeopardy assessment is appropriate if the interviews and Division records establish:

- The out-of-state vendor refuses to register the business even though the business involves transactions subject to New Jersey sales tax or has employees subject to New Jersey withholding of gross income tax.

- The out-of-state vendor, registered or unregistered, owes several tax returns and/or underpayments of filed returns. No information is offered by the vendor nor is information readily available to tie the vendor to substantive New Jersey assets such as real property that could serve as surety upon which a lien can attach. There is evidence that business activity began prior to this encounter.

- The in-state vendor refuses to register the business that involves transactions subject to New Jersey sales tax or who has employees subject to New Jersey withholding of gross income tax. No information is readily available to tie the vendor to substantive New Jersey assets upon which a lien can attach, such as real property, or a lease for a fixed business location in New Jersey.

- The in-state vendor owes several tax returns and/or underpayments of filed returns. No information is readily available to tie the vendor to New Jersey based assets upon which a lien can attach, such as real property, or a fixed business location in New Jersey. There is evidence that business activity began prior to this encounter.

- The out-of-state corporation has not been authorized by the New Jersey Secretary of State to conduct business in New Jersey and as an unauthorized foreign corporation has not filed returns or paid the Corporation Business Tax due for the years in which the corporation conducted business in New Jersey. The out-of-state corporation is not immune from the New Jersey franchise tax imposed for the privilege of having or exercising its corporate charter in New Jersey or doing business in New Jersey. While Federal Public Law 86-272 prohibits a state from imposing a tax on income derived by a foreign corporation from interstate commerce with many limitations, it does not protect a corporation from having to file and pay the minimum tax of the Corporation Business Tax. If the corporation conducts activities not protected by Federal Public Law 86-272, the income is not protected and is subject to tax calculated on income of the Corporation Business Tax.

- The out-of-state vendor refuses to comply with New Jersey tax laws yet avails itself of the benefits of the New Jersey economic market. Physical presence nexus may be created by delivery to New Jersey with the vendor's own vehicle, even if leased, inventory is maintained in a New Jersey warehouse or other New Jersey location, vendor's representative is in New Jersey to further the business by soliciting sales or providing services.

If the facts and circumstances support a jeopardy assessment, it is made immediately, and an administrative Warrant for Jeopardy Assessment is issued. Arrangements are made for the transfer of guaranteed funds to satisfy the assessment. The Warrant includes the details concerning the company's rights to appeal the jeopardy assessment, including the filing of an administrative protest with the Division's Conference and Appeals Branch; the filing of a complaint in the Tax Court of New Jersey; and the refund claim process.

The jeopardy assessment process has been successful in leveling the playing field for the vendors who comply with our tax laws by taking away the competitive advantage gained by those who evade their obligations to the State of New Jersey. It is a program that has resulted in the registration of more than 10,000 vendors, now New Jersey taxpayers, and the collection of $100 million in tax revenue due to New Jersey. By paying their obligations and playing by the rules, tax compliant businesses make an investment in their state and their future. New Jersey has an obligation to protect this investment by making sure all businesses follow the same rules.

I thank you for this opportunity to present the position of the New Jersey Division of Taxation.

Very truly yours,

Maureen Adams
Director
Division of Taxation

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Partnership for New York City

TESTIMONY SUBMITTED TO THE HOUSE JUDICIARY COMMITTEE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

TUESDAY, JUNE 24, 2008

KATHRYN WYLDE
PRESIDENT & CEO
PARTNERSHIP FOR NEW YORK CITY

Thank you Chairwoman Sanchez, and members of the Subcommittee, for the opportunity to submit testimony.

The Partnership for New York City is a nonprofit organization of international business leaders and major employers who are dedicated to keeping our city the center of world commerce, culture and innovation. We strongly support H.R. 5267, the Business Activity Tax Simplification Act of 2008 ("BATSA"), and its Senate version, S. 1726, the Business Activity Tax Simplification Act of 2007.

BATSA would ensure that companies are subject to state business taxes only in those states where they have a physical presence and from which their business operations and employees derive benefits. It would stop the practice begun recently by some states of taxing corporations based on where their customers, rather than their businesses, are located. This practice has resulted in significant new impositions on companies, in terms of both tax payments and compliance costs associated with responding to widely varying and constantly changing taxing schemes adopted by various jurisdictions.

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New York City is a major hub for interstate commerce and many New York-headquartered companies transact business in all fifty states and around the world. New York City and State incur huge expenses to supply the infrastructure and services necessary to accommodate these companies. Traditional practice in the U.S. has been that states levy business activity taxes only on those businesses that have some type of physical presence (i.e., labor force or property) in the state. We support this tradition, which is based on the premise that a business should pay tax only to those jurisdictions that have provided it with meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers). Businesses receive these benefits only from the jurisdictions where they are actually located. Businesses should only pay tax where they actually earn income, and economists agree that income is earned where a business employs its labor and capital.

BATSA would provide the clarity and discipline required to maintain a rational and hospitable business environment in the United States. It will also protect the tax base of America's major commercial centers that are absorbing the costs associated with the demands of major commercial operations.

A memorandum discussing these issues in more detail follows this testimony. Thank you for your consideration.

The Partnership for New York City
Supports the Business Activity Tax Simplification Act

The Partnership for New York City strongly supports H.R. 5267, the Business Activity Tax Simplification Act of 2008 ("BATSA"), introduced on February 7, 2008 by Representatives Boucher and Goodlatte, and S. 1726, the Business Activity Tax Simplification Act of 2007, previously introduced by Senators Schumer and Crapo.

With a mission to maintain the City's position as the global center of commerce and innovation, the Partnership for New York City is an organization of the leaders of New York City's top corporate, investment, and entrepreneurial firms. They work in partnership with City and State government officials, labor groups, and the nonprofit sector to enhance the economy and culture of the City. The Partnership focuses on research, policy formulation, and issue advocacy at the City, State, and federal levels by leveraging its network of CEO partners. Through its affiliate, the New York City Investment Fund, the Partnership directly invests in economic development projects in all five boroughs of the City.

I. The Issues Confronted by Multistate Businesses

With advances in modern technology and the advent of the Internet and electronic commerce, businesses today are able to engage in a variety of business transactions with customers throughout the country with fewer geographical constraints than ever before. As the American economy has become more integrated, the debate surrounding the issue of when a state or local taxing authority has jurisdiction to impose a direct tax on the activities of an out-of-state business has intensified. The cause of much of this debate is the lack of a uniform nexus standard and the outdated provisions of a federal statute known as Public Law 86-272.[1]

Traditionally, states and localities have levied business activity taxes only on those businesses that have some type of physical presence (i.e., labor force or property) in the jurisdiction. However, in recent years, some states have asserted that a business's economic presence in the state – for example, merely having customers in a state – is sufficient to subject that business to tax.[2] Members of the business community continue to believe that some type of physical presence in a state or locality is necessary before tax may justifiably be imposed on an out-of-state business.[3] The issue of a proper

[1] Public Law 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).

[2] A survey conducted by BNA Tax Analysts demonstrates the extent to which the states are asserting the right toimpose tax on out-of-state businesses based on so-called "economic nexus" grounds. *Special Report: 2006 Survey of State Tax Departments*, 13 Multistate Tax Rep't 4 (April 28, 2006).

[3] *See* Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcommittee on Commercial and Administrative Law of the House Comm. Of the Judiciary, 108th Cong. (2004) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair

jurisdictional standard has been litigated, but state courts and tribunals have rendered conflicting decisions.[4] Unfortunately, the U.S. Supreme Court has declined to rule on the issue, which has created an environment of uncertainty and unpredictability for multistate businesses.[5] As states become more aggressive in their attempts to assert taxing jurisdiction based on economic nexus principles, the need for certainty has become more urgent.[6]

Further exacerbating the jurisdictional issues faced by multistate businesses are the outdated provisions of Public Law 86-272. Public Law 86-272 is a federal law that prohibits states from imposing a net income tax on businesses whose activities in the state are limited to the solicitation of sales of tangible personal property, provided that the orders are accepted outside the state and the goods are shipped or delivered from outside the state. The law was enacted over forty-five years ago and it has not been amended to keep pace with the changing nature of the American economy. Specifically, Public Law 86-272 only protects the solicitation of orders for tangible personal property, but over the last few decades the economy has shifted its focus from tangible goods to services and intangibles, such as intellectual property. Further, Public Law 86-272 only protects businesses from net income taxes and the number of states that have enacted non-income based business activity taxes, such as gross receipts taxes, has grown dramatically in recent years. These outdated provisions of Public Law 86-272 must be adapted for our modern economy.

These issues are of particular concern to the Partnership because of our concern about New York City's economy. New York City has long been a major hub for interstate commerce and is home to over 200,000 business establishments.[7] New York City companies transact business in all fifty states and around the world. These problems faced by multistate businesses have reached a critical point and should be addressed by Congress.

II. Summary of BATSA

Taxation, Jamie Van Fossen, Chair of Iowa House Ways and Means Committee, and Vernon T. Turner, Smithfield Foods, Inc.).

[4] *Compare A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied* 546 U.S. 821 (2005); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied* 127 S. Ct. 2974 (2007); *and Tax Comm'r of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d (W. Va. 2006), *cert. denied* 127 S. Ct. 2997 (2007); *with Acme Royalty Co. v. Dir. Of Revenue*, 96 S.W.2d 72 (Mo. 2002); *J.C. Penny Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied* 531 U.S. 927(2000); *and Rylander v. Bandag Licensing Corp.*, 18 S.W. 3d 296 (Tex. App. 2000).

[5] *See, e.g., Lanco, Inc. v. Director, Division of Taxation*, 188 N.J. 830 (2006), *cert. denied*, 127 S. Ct. 2974 (2007); *Tax Comm'r of West Virginia v. MBNA America Bank, N.A.*, 220 W. Va. 163, *cert. denied*, 127 S. Ct. 2997 (2007).

[6] For example, New Jersey recently attempted to impose tax on a family-owned software company based in South Carolina, which had no physical presence in New Jersey, solely because the company sold licensed software to a New Jersey entity. *See* Floor Statement of Congressman Rick Boucher on Introduction of The Business Activity Tax Simplification Act of 2008 (Feb. 7, 2008).

[7] *See* Baruch College, "NYCdata" available at https://www.baruch.cuny.edu/nycdata/.

BATSA has two main components. First, BATSA adopts a physical presence jurisdictional standard. Specifically, a state or local taxing authority may not impose a business activity tax on an out-of-state business unless the business has a physical presence (i.e., employees, property, or the use of third parties to perform certain activities) in the taxing jurisdiction. BATSA also provides exceptions for certain quantitatively and qualitatively *de minimis* activities. Quantitatively, a business must have physical presence in a taxing jurisdiction for at least 15 days to be subject to tax in the jurisdiction. Additionally, a business's presence in a state to conduct limited or transient business activities is viewed as being qualitatively *de minimis* and will be disregarded in determining whether the business has met that 15-day physical presence threshold.

Second, BATSA modernizes the provisions of Public Law 86-272. BATSA extends the protections of Public Law 86-272 to the solicitation of orders for services and intangible property, rather than just tangible personal property. BATSA also treats certain qualitatively *de minimis* activities in the same manner as mere solicitation. These protected activities include those conducted for the purpose of patronizing the local market (i.e., acting as a customer), as opposed to exploiting the local market or those involving the furnishing of information to customers or affiliates. BATSA also broadens the scope of Public Law 86-272 to apply for purposes of all business activity taxes, rather than just net income taxes. BATSA does not apply to transaction taxes such as sales and use taxes.

III. BATSA Provides the Proper Solution to the Issues Faced by Multistate Businesses

BATSA provides the appropriate solution to the two major state tax jurisdictional issues currently faced by multistate businesses by adopting a uniform physical presence nexus standard and modernizing Public Law 86-272.

It has long been accepted that taxes should, at least in part, be payments for benefits and services received from the government.[8] Proponents of an economic nexus standard argue that an out-of-state seller receives the benefit of a "viable marketplace" from a remote market state, which justifies the imposition of a tax on the activities of that out-of-state business.[9] However, focusing solely on the seller "exploiting" a market fails to recognize the basic economic truth that the customer derives as much benefit from a voluntary transaction as does the seller and the basic political truth that state governments maintain a "viable marketplace" for the benefit of their constituents, the in-state customers, and not for the benefit of out-of-state sellers.

Further, the imposition of a business activity tax on an out-of-state seller cannot be justified on the basis that the government has provided some nebulous and incidental benefit. Rather, the benefits and protections provided by a taxing jurisdiction must be meaningful. Businesses only receive meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers) in the jurisdictions where

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[8] *Wisconsin v. J.C. Penny Co.*, 311 U.S. 435 (1940).
[9] *See* Tax Section of the New York State Bar Association, "Nexus Requirements for Imposition of Business Activity Taxes" (January 23, 2008).

they are actually located due to the presence of a labor force or property. Thus, businesses should only pay tax where they have a physical presence.

Proponents of an economic nexus standard further argue that without sales businesses would have no income. But, businesses should only pay tax where they *earn* income, and economists agree that income is earned where a business employs its labor and capital (i.e., where a business is physically present). This is abundantly clear when one considers an individual "telecommuter" whose employer is in a different state. Where does the telecommuter "earn" his or her income? He or she earns that income where he or she actually performs business activities, rather than where the employer, which is the customer for the individual's services, is located. Like telecommuters, the location of a business's customers is irrelevant because a business earns its income where it actually engages in business activities. Those who say that income is earned where customers are located because without customers there can be no profit would have to say that an employee earns income where his or her employer is located because without an employer there can be no wages, which obviously makes no sense.

A physical presence nexus standard is also desirable because an economic nexus standard would increase compliance costs and administrative burdens for both taxpayers and taxing authorities. Over 3,000 state and local taxing jurisdictions currently impose some type of business activity tax and over 9,000 more have the authority to impose such taxes but do not currently do so.[10] With today's modern technology, even the smallest companies can transact business with customers in all fifty states. As more state and local taxing authorities attempt to assert jurisdiction over out-of-state businesses based solely on economic nexus grounds, these small companies could be subject to business activity taxes in thousands of state and local taxing jurisdictions. Taxing schemes (e.g., filing methods, tax base computation, apportionment formulas) vary widely from jurisdiction to jurisdiction,[11] and taxpayers would have to track these differences, as well as any legislative and regulatory developments, in each of these jurisdictions. Although some opponents of BATSA have claimed that the provisions favor big businesses,[12] it is small and medium sized businesses that would be disparately impacted if states continued to shift towards an economic nexus standard due to the regressive nature of compliance costs.[13] Some state tax administrators have acknowledged that an economic nexus standard is more difficult and costly for state taxing authorities to administer and enforce.[14] Proponents of economic nexus ignore these very real practical considerations.[15]

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[10] Ernst & Young, "State and Local Jurisdictions Imposing Income, Franchise, and Gross Receipts Taxes on Business," March 7, 2007.

[11] *See* Brief of Amici Curiae Council on State Taxation, et. al., *MBNA America Bank, N.A., v. Tax Commissioner of the State of West Virginia*, 127 S. Ct. 2997 (cert denied) (No. 06-1228) and *Lanco, Inc. v. Director, Division of Taxation*, 127 S. Ct. 2974 (2007) (cert. denied) (No. 06-1236).

[12] *See, e.g.,* Matt Tomalis, *Some Fatal Flaws of S. 1726, H.R. 5267 and All BAT Nexus Bills*, 47 State Tax Notes 691 (Mar. 3, 2008).

[13] Sanjay Gupta and Lillian Mills, *How Do Difference in State Corporate Income Tax Systems Affect Compliance Cost Burdens?*, March 2002.

[14] *See, e.g.,* Eugene F. Corrigan, *States Should Consider Trade-Off on Remote Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

[15] *See* Tax Section of the New York State Bar Association, "Nexus Requirements for Imposition of Business Activity Taxes" (January 25, 2008).

The BATSA physical presence test would also provide clarity and predictability for businesses. Companies must be able to predict and estimate future tax burdens with some degree of accuracy in order to engage in strategic planning and budgeting. Companies must also be able to accurately quantify future tax liabilities for financial reporting purposes.[16] Under an economic nexus standard, both the particular jurisdictions and the number of jurisdictions in which a business must pay tax can change solely because a new customer located in a particular state chooses to buy its product or because an existing customer decides to migrate to a different state. If businesses cannot accurately predict their future tax liabilities, they cannot be expected to provide meaningful disclosures to investors.

A physical presence nexus standard is also consistent with the jurisdictional standard that has been used and relied upon in the international tax context for over 80 years. The United States, along with most other countries, has adopted a "permanent establishment" standard in its bilateral tax treaties. The permanent establishment standard requires taxpayers to have a fixed place of business through which the business of the enterprise is wholly or partly carried on – in other words, a physical presence – in order for a foreign country to impose an income tax on the business's profits.[17] Hundreds of bilateral international tax treaties have adopted this "permanent establishment" standard, providing uniformity, predictability and certainty for multinational businesses for decades.[18] If states were to decouple from this physical presence standard, it would likely result in reduced inbound investment and trade and, more alarmingly, retaliation by foreign countries against U.S. corporations abroad.

Along with providing a physical presence nexus standard, BATSA would modernize the provisions of Public Law 86-272. Public Law 86-272 was originally enacted in the wake of a U.S. Supreme Court decision that authorized the taxation of an out-of-state corporation whose only contacts with the state were salespeople permanently assigned to the company's in-state sales office.[19] Members of the business community were concerned that, as a result of this decision, states would begin to tax out-of-state businesses with unfettered authority. Congress responded by enacting Public Law 86-272, indicating clear policy judgments that solicitation activities create an insufficient connection with a jurisdiction to justify the imposition of a direct tax and that protecting such activities would help build a strong and unified American economy. These policy concerns remain just as strong today, and to carry out these policies in today's modern economy the provisions of Public Law 86-272 should be updated.

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[16] The Financial Accounting Standards Board ("FASB") recently issued FASB Interpretation Number 48 ("FIN 48") which provides rigorous criteria for accounting for uncertain income tax positions (including the decision not to file a return in a particular jurisdiction) for financial statement purposes.

[17] *See* Testimony of Michael F. Mundaca Before the Senate Committee on Finance, Subcommittee on International Trade, "How Much Should Borders Matter?: Tax Jursidiction in the New Economy" (July 25, 2006).

[18] *Id.*

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

In today's economy, more and more businesses are selling intangible products and services rather than tangible goods. Because Public Law 86-272 only protects the solicitation of orders for tangible personal property, many important sectors of the economy are not receiving the protections of the law. BATSA appropriately extends the protections of Public Law 86-272 to sales of all types of property and services, rather than just tangible goods.

BATSA would also modernize the provisions of PL 86-272 to apply to all types of business activity taxes. An increasing number of states are adopting non-income based taxing schemes. For example, Ohio has implemented a Commercial Activity Tax, effective July 1, 2005, which imposes a business activity tax based on gross receipts.[20] More recently, Texas enacted a Margins Tax that imposes a business activity tax based on gross margin (i.e., gross receipts less either cost of goods sold or compensation).[21] What is most distressing about this trend is that many of these non-income based taxing schemes are specifically intended to circumvent the restrictions of Public Law 86-272. For example, New Jersey imposes an alternative minimum assessment based on gross receipts, but *only* on businesses that are exempt from corporate income tax pursuant to Public Law 86-272. [22] In light of many states' current fiscal situations, more states will likely explore the option of adopting these non-income based taxes. Allowing states to avoid the restrictions of Public Law 86-272 by enacting taxes that are not calculated based on income, but that essentially have the same effect (i.e., imposing a direct tax on a business's activities), would undermine the original purposes of the law.

The bright-line physical presence test in BATSA provides the most fair and equitable standard for multistate taxpayers, and the modernization of Public Law 86-272 is necessary in light of the changes that have occurred in our national economy.

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[20] *See* Ohio Rev. Code §5751.01 *et. seq.*
[21] *See* Texas Code § 171.0001 *et seq.*
[22] *See* N.J. Stat. Ann. 54:10A-5ae.

WRITTEN STATEMENT OF

CAREY J. (BO) HORNE
PAST PRESIDENT
PROHELP SYSTEMS, INC.

and

KATHERINE S. HORNE
PAST VICE PRESIDENT
PROHELP SYSTEMS, INC.

IN SUPPORT OF H.R. 5267

"THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT"

to the

COMMITTEE ON THE JUDICIARY

COMMERCIAL AND ADMINISTRATIVE LAW SUBCOMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

for the hearing to be held

June 24, 2008

Small Businesses Face an Impossible Situation

Small businesses have always faced great challenges. Today, we confront the greatest ever. Caught in the middle of an enormous struggle between large businesses and greedy states over highly complicated tax nexus issues, small businesses are left in an **impossible** position. The ability of our smallest businesses to participate in Interstate Commerce in the future is now **literally** at stake.

Highly aggressive, quickly expanding, and even abusive tax nexus claims made by **many** states amount to nothing short of legalized extortion. Except such claims are of dubious Constitutionality. The Supreme Court has said de minimis activity is insufficient for creating nexus. But, because such activity has not been adequately quantified into Federal law by Congress or by the Courts, the states are using every contrivance possible to defy past decisions which are very clear to the average citizen.

The result is now propelling our Nation quickly toward the very scenario which compelled our Founders to include the Commerce Clause in our Constitution. Just as occurred under the Articles of Confederation, greedy, revenue-hungry states are today seriously harming our Nation's economy. Our own personal experience clearly illustrates how real the problem is and how terribly extreme state nexus laws have become. No entrepreneur who adequately understands the liabilities facing the smallest businesses today would *ever* contemplate launching a new business that would depend on making interstate sales of any type or size.

The Supreme Court has declined to become further involved in this issue. Only strong action by Congress can now prevent major damage to our fragile economy and avert the ***complete closure of interstate markets to our Nation's smallest businesses.***

The Problem is Very Severe:

In 1997, our tiny **home-based**** business, with annual **sales** of under $100,000, made a **one-time** sale of our proprietary software to a customer in New Jersey for $695. When it became aware of this single sale in 2003, the State of New Jersey demanded that we pay approximately $15,000 in back taxes, fees, interest, and penalties. The State further demanded that we also pay $600 in taxes and fees, ***every year thereafter as long as our customer used the software, even in years when no sales are made in New Jersey, and regardless of any profit.*** Since then, New Jersey has become even more punitive against businesses located elsewhere, and numerous other states have launched similar programs to export their local tax burdens. **Located in Georgia in 1997, re-located to South Carolina in 2001.

The abuses are ***not*** limited to software. New Jersey and other states defy protections of the Interstate Income Tax Act of 1959 (Public Law 86-272), which prevent any state from imposing an income tax for interstate activities where no physical presence exists. Today, if one of your constituents ships a box of paper clips to a customer in New Jersey, he is exposed to similar claims.

Only after more than two years of intense effort that should have gone toward growing our business, after great legal expense had been incurred, and after our case had brought massive negative publicity to the State, did New Jersey ultimately drop its claim against our company. We received no apology or compensation for the abusive claims; and we are ***still*** precluded from making sales ***from our home*** in South Carolina to customers in New Jersey without exposing ourselves to the same ordeal, again.

When I testified [1] to the House Judiciary Subcommittee on Commercial and Administrative law in 2005, Congressman Delahunt immediately understood what the future holds for small businesses:

> "The case presented by Mr. Horne, I think, is an ***egregious*** example.
> We support you, Mr. Horne, and it's got to be addressed."

The nightmares being reported are certain to escalate. New Jersey increased its minimum tax ***150%*** in 2002. Such taxes are effectively borne only by the smallest participants in Interstate Commerce. The victims are generally not capable of fighting, they capitulate to reduce the risk of larger penalties, and they have absolutely no representation in the matter ***except right here in the Congress***.

Without clear protections such as BATSA provides, aggressive states will always seek to stretch the limits and to impose their own creative definitions to justify taxation most citizens would consider unjust. Similar business activity taxes have already spread to Michigan, Ohio, Texas, and many other states. Can anyone believe they will not soon be implemented by **all** states? **Every state**, even those who understand the damage being done, will be **forced** to implement similar taxes for **retaliatory** reasons. Each state will be **forced** to recoup its own legitimate tax revenues siphoned off by the more aggressive states acting before them. ***The inevitable result will be the complete closure of interstate markets to our Nation's smallest businesses, and great damage to our National economy.***

The Impossible Situation:

As documented by numerous large businesses, including Smithfield Foods during the 2004 BATSA hearing, the burden of complying with so many widely varying tax laws is enormous. **Small** businesses find actual compliance to be **impossible** and even the **expectation** of compliance to be **completely unreasonable**. For these reasons, the Supreme Court has declared such claims against small businesses to be unconstitutional, in multiple major decisions such as Complete Auto Transit.

As indicated earlier, the states simply ignore the **total impossibility** for any small business to:

- Become familiar with the widely varying and ever changing nexus and tax laws of 50 States, let alone comply with them. How will mom and pop businesses **ever** be able to comply?
- Deal with the staggering burden of 12,000 differing nexus laws and business activity taxes authorized by the states for their localities. How can **any** small business handle such magnitude?
- Cope with the staggering variety of minor yet very common business activities, shown on page 6, that subject them to abusive assertions of interstate nexus.
- Devote the administrative resources necessary to keep business activity records for 50 states and 12,000 localities. Why should we even have to try?
- Find funding for the preparation of **totally different** tax returns for up to 50 states and 12,000 localities. How could **any** government unit even expect us to attempt this?
- Pay $30,000 per year, or even more, every year **forever** in minimum business activity taxes and fees, **even if no sales are made anywhere.** This will be the result for **every** small business, regardless of sales or profits, when all 50 states adopt New Jersey's Corporate Business Tax and a single de minimis sale has been made, in some prior year, in every state. It will be even worse when localities are included. Much history, past and current, has proven such abusive claims against our Nation's small businesses **will occur** unless Congress acts decisively to protect us.
- Once confronted with an abusive claim, find an affordable attorney who is knowledgeable about interstate nexus issues. When faced with the issue in 2003, calls to every attorney in Atlanta and throughout South Carolina specializing in tax or computer law led to **no one** familiar with our problem. Of course, we did not call the largest downtown firms, because we **knew** we could not afford them. Ultimately, the South Carolina Department of Revenue led us to perhaps the only attorney in South Carolina familiar with interstate nexus issues. He told us, up front, that we could not afford him, but thankfully gave us a lot of very useful advice, pro bono.
- Meet strictly enforced time limits imposed by states for contesting aggressive and even unconstitutional claims. The logistics of finding adequate and affordable representation for a highly complicated issue in a state far away are **insurmountable** for most small businesses.

- Defend itself against an aggressive, far away state. Many of the claims made against small businesses are clearly unconstitutional, on multiple grounds. States are now regularly asserting claims for only de minimis activity in the state. They continue to pursue aggressively even the weakest cases because they know it is **virtually impossible** for small businesses to fight back.
- Finance the defense of an egregious claim all the way to the Supreme Court. The states are taking maximum advantage of a system that requires all tax cases, including those where substantial constitutional issues are involved, to exhaust all legal remedies within the state first. At that point, the only recourse is to the United States Supreme Court. Few, if any, small businesses will find this arduous route anything but **utterly impossible**.

Our Experience is *Not* an Isolated Case:

Our many conversations with people across the country show that abuses are far more common than generally recognized. At the time of my testimony in 2005, we were already personally aware of approximately fifteen small business victims located in multiple states, including three represented by members of the Judiciary subcommittee.

We did not search for these victims. Desperate for help, **they found us**, from testimony we submitted for the 2004 hearing or from numerous magazine and newspaper articles written about our case. Since the 2005 hearing, approximately fifteen **more** businesses have sought us out, also desperate for any help they can find for dealing with their crisis. One of the calls was from a small trade organization representing seafood processors; approximately twenty of their members in the Delmarva area had been trapped. When a tiny, **home-based** business learns of almost **fifty** small companies across the country faced with nexus nightmares, the true extent of the problem must be **enormous**.

We are completely flabbergasted that almost a dozen attorneys from across the country have also called us, trying desperately to learn as much as they can as quickly as they can, in order to provide adequate representation for their local clients fighting battles with far away states.

Each of the Judiciary Committee members should clearly understand that small businesses in ***your own States and in your own districts*** are ***already*** being wrongly burdened by greedy states, because we lack the vital protections every small business **assumes** already exist.

The Solution:

Many small businesses are not yet vocal with their support for the Business Activity Tax Simplification Act ("BATSA", HR-5267 and S-1726). They are generally totally unaware that numerous far away states are now taxing sales they implicitly assume are protected. Most are unaware that states are also now regularly ignoring or circumventing the basic protections granted by the Interstate Income Tax Act of 1959 (PL 86-272).

Most have no idea what nexus is, and don't really want to know. They just want to grow their businesses and help expand the Nation's economy. They have no idea that the sales they are regularly making across state lines, through a physical presence in their home state only, are exposing them to the same nexus nightmares many other small businesses have already encountered.

As the states employ more powerful and more pervasive systems to track the smallest sale made anywhere, small businesses will be regularly trapped like a deer in headlights, totally defenseless against what will soon occur, unless Congress uses its broad authority to protect the right of every small business to participate in Interstate Commerce on a reasonably unfettered basis.

Our personal experience, plus those of other small businessmen testifying to the House Small Business Committee on February 14, 2008, clearly show what happens when the standard leaves the smallest avenue open to abuse by greedy States. ***Without strong Federal legislation, small businesses will soon be unable to participate in Interstate Commerce, on any basis.***

The arguments about state sovereignty and how we must change our tax systems to accommodate the Internet economy are not reasonable for this debate. Small businesses have their backs to the wall. They now face the very situation that caused the Founders to give **you,** the Congress, the power to regulate Interstate Commerce. You **must** now use that power to protect our small businesses and even the entire National economy.

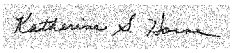
Only a **strong** restatement of the fundamental principles of physical presence will resolve the tragic and **impossible** consequences small businesses are facing. These principles worked so well for more than 200 years that they were simply "understood" and not even codified into law until the Congress did so with the Interstate Income Tax Act of 1959.

It is now **urgent** that this Congress modernize that Act quickly to protect our small businesses and our National economy. The Act must be expanded to cover all types of sales, both products and services, and it must prohibit all types of business activity taxes which are so harmful to the smallest of businesses.

Having faced this issue, up close and personal, for almost five years, we know the Business Activity Tax Simplification Act is ***exactly*** what small businesses need. We urge the Judiciary Committee to use its full resources to insure this bill moves quickly though the Committee and is rapidly passed by the full House of Representatives and Senate. Only then can our Nation's small businesses safely redirect their full energies to growing our economy instead of defending themselves against egregious claims of nexus made by a rapidly growing number of states.

Our economy is in great peril. Our Nation cannot afford to allow nexus abuses to damage it further.

Carey J. Horne
Past President



Katherine S. Horne
Past Vice President

ProHelp Systems, Inc. [2]
418 East Waterside Drive
Seneca, SC 29672

[1] Testimony and complete transcript of the hearing with Mr. Delahunt's comments are available at this link: http://judiciary.house.gov/Hearings.aspx?ID=124 The oral testimony and additional written information, exactly as submitted to the Subcommittee, are also included below beginning on page 7.

[2] ProHelp Systems, Inc. was a Georgia Corporation, chartered in 1984. It was dissolved in 2007 because of our inability to deal with the complexity of the interstate tax and nexus issues we faced.

Small Businesses Face Nexus Nightmares - 2007

More information is available at www.tinybusinesstaxnightmares.com

Be Careful - Even de minimis Activity in Many States Can Easily Trap Small Businesses!

No of States [1]	Activity Within State Causing Nexus; Business is NOT Physically Present Unless Noted
	Making a Sale is NOT Required to Cause Nexus:
3	Occasional attendance at training or technical seminar, sponsored by unrelated party
26	Occasional business meeting in state at customer site
11	Participation in trade show, up to 14 days/year, no tangible property is brought to show
26	Business provides supplies or equipment free of charge for special events in the state
8	Truck merely passes through state, no deliveries or pickups are made, six or fewer times/year
10	Truck merely passes through state, no deliveries or pickups are made, up to twelve times/year
10	Truck merely passes through state, no deliveries or pickups are made, more than twelve/year
36	Business merely solicits for sale of services, is present in state six or fewer days per year
15	Business is present in state merely to **purchase** goods or services, twenty or fewer days/year
8	Business has listing in a telephone book for a city within the state
23	Business uses telephone answering service within the state
37	Business owns tools/dies located in the state, used by a supplier **charging** for his services
31	Inventory is temporarily in the state, for processing by supplier **charging** for his services
8	Business sends records to an in state bookkeeper, who **charges** for the services
3	Business opens an account with a bank in the state, which **charges** for its services
5	Business obtains a loan from a bank in the state, which **charges** for its services
33	Business uses in state credit service to check credit for new customers in state
18	Business uses in state collection agency, which **charges** for its services
	Presence in State is NOT required to Cause Major Nexus Issues:
4	Business advertises in the state and takes orders outside the state via telephone
15	Website is hosted on server in state; a sale may not even be required!
3	Website is merely accessible in state, not hosted there, and sales are protected by PL 86-272
8	Business has a link on its website (not in this state) to a business located in the state
24	Canned licensed software is sold to a customer in the state
43	Services are sold in the state, no physical presence exists
20	Tax return must be filed even when sales are protected by PL 86-272
7	Business files a registration of some type with state agencies
NJ,MI,OH,TX,WA [2]	***Anything*** is sold in the state; the protections of PL 86-272 do not apply!
	Even Minor Presence Causes Major Nexus Troubles:
40	Business is present to provide consulting services, six or fewer days per year
17	Business is present for one day and one de minimis sale occurs
37	Business is present for one day and one non-de minimis sale occurs
15	Business makes occasional deliveries in state by company truck
28	Products are shipped in returnable containers to customers in state

[1] Indicates the number of states asserting they can subject a business to a business activity tax based solely on the business conducting the listed activity in the state, according to the state tax revenue departments' own responses compiled in the 2007 BNA Survey of State Tax Departments and Healy & Schadewald's Annual Revenue Department Survey, printed in 2007 CCH Multistate Corporate Tax Guide, Volume 1, Corporate Income Tax.

[2] This activity was determined independently, not from the referenced studies.

STATEMENT OF

CAREY J. (BO) HORNE
PRESIDENT
PROHELP SYSTEMS, INC.

on the

"THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT"

before the

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

of the

COMMITTEE ON THE JUDICIARY
U.S. HOUSE OF REPRESENTATIVES

September 27, 2005
Room 2141, Rayburn House Office Building

House Subcommittee on Commercial and Administrative Law

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

IN SUPPORT OF H.R. 1956
"THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT"

September 27, 2005

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.

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 two 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, 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 to customers 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 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.

Carey J. Horne, ProHelp Systems, Inc.

Carey J. "Bo" Horne is President of ProHelp Systems, Inc., a software development firm located in Seneca, South Carolina. Founded by him in 1984, ProHelp designs, develops, and markets highly complex and specialized product configuration, engineering, and manufacturing software systems for major electrical equipment manufacturers. Engineering software developed by ProHelp has been designated as "best in our world-wide organization" by a large, multi-national manufacturer. ProHelp also creates systems integration software for midrange and mainframe markets, including printing and communications utilities used by programmers throughout the world.

Bo began his career with the Cutler-Hammer products group of Eaton Corporation and held various management positions in engineering, materials, manufacturing, and information technologies within the Industrial Control Group. With a strong background in all disciplines of plant operations, he is an acknowledged expert in Motor Control Centers and has developed comprehensive engineering software for three of the top five manufacturers. He developed the industry's first product configuration system for Motor Control Centers provided directly to architects, design engineers, and electrical distributors.

He is a summa cum laude graduate of The Georgia Institute of Technology with a degree in Electrical Engineering.

Statement of the Securities Industry and Financial Markets Association
Submitted to the House Judiciary Subcommittee on
Commercial and Administrative Law
June 24, 2008

H.R. 5267, the Business Activity Tax Simplification Act

The Securities Industry and Financial Markets Association (SIFMA)[1] supports H.R. 5267, the *Business Activity Tax Simplification Act* ("BATSA"). This important legislation would provide necessary clarity regarding the application of state or local government business activity taxes to companies that do not have a physical presence in the taxing jurisdiction. The bill would provide this clarity by establishing bright lines specifying the amount of physical presence in the jurisdiction needed to trigger tax liability.

In 1992, the U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that a state could not require an out-of-state business to collect sales and use tax unless that business has a "substantial nexus" within the taxing state. At that time, the Supreme Court declined to explicitly rule on the nexus standard as applied to business activity taxes. Many tax experts inferred that the same standard logically should be applied in the case of the direct imposition of business activity taxes. Unfortunately, over time, state and local governments have increasingly sought to define "substantial nexus" much more expansively, leading to costly litigation and uncertainty for both business taxpayers and state and local governments.

More recently, the U.S. Supreme Court refused to review two lower court cases that challenged the constitutionality of state efforts to tax out-of-state companies based on "economic presence" rather than "physical presence." Refusal to review these cases has added to the existing uncertainty and increased the

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues.

Washington ▪ New York ▪ London ▪ Hong Kong
1101 New York Avenue NW, 8th Floor ▪ Washington DC 20005-4629 ▪ P:202.962.7300 ▪ F:202.962.7305 ▪ www.SIFMA.org

need for Congressional action to clarify when a state can tax a business with little or no physical presence in the state.

BATSA removes confusion and the potential for double taxation inherent in the absence of clear rules specifying when state or local governments can impose business activity taxes. This is particularly important to the financial services industry because some jurisdictions seek to impose business activity taxes on companies that have no physical presence in the state but that increasingly serve customers remotely through mail and the internet.

By establishing clear and consistent bright-line standards, H.R. 5267 will provide certainty in interstate commerce to both businesses and to state and local governments. SIFMA urges Congress to act on this important legislation.

Software & Information Industry Association
1090 Vermont Ave NW Sixth Floor
Washington, DC 20005-4095

June 20, 2008

The Honorable John Conyers
Chairman, Committee on the Judiciary
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Conyers and Members of the Committee:

On behalf of the Software & Information Industry Association (SIIA), I urge you to support H.R. 5267, the Business Activity Tax Simplification Act (BATSA), legislation to establish a bright-line physical presence nexus standard to clarify that physical presence is the constitutional standard for imposition of business activity taxes.

As the principal trade association of software and digital content companies, the more than 500 members of SIIA are software companies, e-businesses, and digital information service companies. The software and information industries are critical drivers of the U.S. and global economies, as they are among the fastest growing and most important industries. In 2005, these industries grew nearly 11 percent, compared with 3.2 percent for the economy as a whole.[1]

Over the past several years, there has been a dramatic increase in state efforts to collect business activity taxes from non-resident businesses. This unfair and troubling practice poses a substantial threat to high-growth technology companies that comprise SIIA's membership, particularly smaller and medium-sized entrepreneurial companies that do not have the resources to spend on litigation to fight unfair and unlawful state audits.

If enacted, H.R. 5267 would establish a bright-line physical presence nexus standard for states to apply in assessing business activity taxes. Importantly, the legislation would not impose any new restrictions on states' taxing power, rather it would merely clarify states' existing authority to tax interstate commerce.

Enactment of H.R. 5267 is critical to ensure the continuation of a legal framework that encourages investment in the digital marketplace and the benefits it provides for interstate commerce. If the digital marketplace and interstate commerce continue to be stifled by unfair state taxation practices, all states—and the U.S. economy—will suffer the consequences.

Thank you for your attention to this important issue. I urge you to support H.R. 5267.

Sincerely yours,

Ken Wasch

Ken Wasch
President

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[1] *Software and Information: Driving the Global Knowledge Economy*, Software &Information Industry Association, 2008. (http://www.siia.net/estore/globecon-08.pdf)

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Testimony of Barry Godwin

Before the United States House of Representatives
Committee on the Judiciary
Commercial and Administrative Law Subcommittee

June 24, 2008

I. Introduction

Ms. Chairwoman and Members of the Subcommittee, thank you for inviting me to express my views concerning H.R. 5267, the Business Activity Tax Simplification Act, and the issues it addresses.

I am the Controller at Stingray Boat Company. Like most small business managers, I have multiple responsibilities and perform various tasks. Stingray Boat Company was founded by Al Fink in 1979, where Al remains the President of the company. Al Fink remains keenly involved in the company, from its roots to the top. Stingray Boats is located in Hartsville, South Carolina, employing 240 individuals full time. We are, by all standards, the epitome of the American Dream, and a small business proudly dedicated to our employees and their families. Stingray builds fiberglass boats from 18 to 25 feet in length. We ship to almost every state within the United States, Canada, Europe and Australia.

In my testimony, I will relate three differing experiences that I have had with three different states. I am seeking clarification of P.L. 82-272, as each state is interpreting how tax nexus has occurred between us and them. The burden placed upon Stingray is to incur legal fees, accounting fees and time to address each state as they seek to attach an economic nexus to

Stingray business activities. This is another tax in addition to the sales tax incurred by the independent dealer in the jurisdiction of that state.

Until three years ago, we were unaware of nexus implications as it relates to taxes. In 2005, we began to hear more about nexus. We became aware of where the State of New Jersey had stopped another boat manufacturer's boat load due to nexus issues. We researched what nexus meant to us. Our activities within all states are the same. We operate according to P.L. 82-272. Our boats are sold to independent dealers. All orders are taken within the State of South Carolina via the telephone or internet. Boats are paid for before delivery is taken by the dealer. Sales representatives from Stingray may travel to see a dealer from time to time but do not operate a "Stingray office" within that state. Dealers visit Stingray each year to review new products and test drive the boats. The boats may be delivered to the dealer on our trucks or by a contract carrier. We reimburse the dealer for warranty work performed by them on our boats. We believe we are operating within the law.

II. The State of Maine vs. Stingray

In 2006, a revenue agent from the State of Maine sent a letter to us regarding our actions within that state. I responded to Mr. Flynn (representing the State of Maine), that we believed that we were operating within the confines of the law. After I had completed a nexus questionnaire, Mr. Flynn told us that we had created nexus by paying the independent dealer for warranty work performed on one of our boats. Stingray did not perform the work, but because

we had paid the dealer our action created nexus. I objected to the revenue agent, but we decided it would be less costly to pay the retroactive taxes and fines than to pursue the matter in the courts. The State of Maine agreed to require us to file from 2003 through 2005 and abate any penalties during this period.

III. Washington State vs. Stingray

In mid 2006, we received notification from Washington State that we had created nexus with that state as well. In this case, revenue agent DeLay cited that we had significant activities within the state of Washington which created tax nexus. Mr. DeLay told me that because we were a member of the Northwest Marine Trade Association (NMTA) it demonstrated that maintaining a market in Washington State was crucial to Stingray, thereby creating "significant activity" and nexus. We maintained a membership in the NMTA to receive a manufacturers discount on floor space at the boat show for the dealers in the state and hold our spot for floor space in the future. Because of Washington States allegations, we have cancelled our membership in the NMTA.

Mr. Delay cited the fact that our sales representative travels to Washington State as another reason Stingray created nexus. Our sales representative, who lives in Nevada, travels to visit the Washington dealer approximately three times per year. Sales calls to the independent dealers are to discuss improvements to the boats and other business issues. This Washington dealer had approached us to sell Stingrays. The dealer had flown to South

Carolina to meet with our vice-president of sales and company president. The dealer tested our product while here and we mutually agreed we would be good for each other. Since being approved, all orders have been taken via the telephone or the internet. I have appealed to the Washington State Department of Revenue the tax ruling by the tax agent and I am waiting a resolution.

IV. The State of New Jersey vs. Stingray

On July 23rd, 2007 I received a call transferred over from our truck fleet dispatcher at 10:15 am. The person on the other end was Ms. Kostak, a revenue agent for the State of New Jersey. I was immediately told that our truck had been pulled over at the weigh station on the interstate highway and could not move until we paid New Jersey for jeopardy assessment taxes. I asked Ms. Kostak why they were doing this. I was told that we had a dealer in the state of New Jersey. This incident was becoming unbelievable, so I asked her to fax me proof that she was who she said she was. I asked what I could do to let the driver go and I was told to pay them money. I asked how much and I was told it depended upon our sales into New Jersey. I looked up the sales for the past seven years as requested and Ms. Kostak quoted me a figure of $46,200 to release the truck. I then told her I would need to discuss the issue with our company president. Ms. Kostak told me I had until 1pm that day to get them the money or the truck would be impounded and we would need to make arrangements for the driver. I asked her, "Can I not send you a check or work

something out to let the truck pass through New Jersey?" and I was told to wire them the money.

I first talked to our truck driver and asked him what had happened. Our driver was passing through the State of New Jersey carrying a load of boats for deliver into Massachusetts. Our driver told me that the agent pulled his rig over at the weigh station and asked him if we had a boat dealer in New Jersey. The driver had never delivered into New Jersey and told Ms. Kostak that he did not know. (Our driver told me that there were ten other trucks stranded at the weigh station for the same issue.) When he did not know of a New Jersey dealer, he gave Ms. Kostak our home office number and the dispatchers' name. Ms. Kostak called our dispatcher and found out that we have a dealer in New Jersey, asked more probing questions and then was passed over to me.

I then discussed the situation with our company president. We decided to call another boat manufacturer who also had been stopped by a New Jersey revenue agent while transporting boats through New Jersey. Their company president of told us that his boat company had spent over $140,000 in legal fees and the issue was not yet resolved after two years. We were also given the company's legal contact. I contacted the attorney to find out our options. The attorney was not encouraging and did not feel we could win against the State of New Jersey. The attorney told me that it was very likely that unless we paid the amount requested, our trucks would be stopped each time thereafter in New Jersey. The attorney suggested that we pay the amount demanded and then appeal in the tax courts of New Jersey. After consultation with our company's

president, we decided to pay what Ms. Kostak demanded so that we could free our load of boats to be delivered and let our driver go.

I called Ms. Kostak again, by now it was close to 12:30 in the afternoon. I told Ms. Kostak that I was appalled of how the State of New Jersey was operating. I asked her for what reason had we created nexus with New Jersey. I told Ms. Kostak that we believed we were operating within the law. Ms. Kostak told me that because our trucks had delivered our boats into the State of New Jersey that this action created nexus. Ms. Kostak reminded me of the deadline to pay them the money or our boats would be impounded. I knew we had boats to deliver into another state and my only choice was to wire the money, which I did. Ms. Kostak had to certify that the funds were in the bank before releasing our property. Finally, at 1:30pm our truck and driver were on the road again.

When our truck crossed the New Jersey state line, Stingray did not have an outstanding issue, warrant or any other legal matter or business activity with New Jersey. If fact, the State of New Jersey did not know we had an independent dealer in the state. Ms. Kostak gathered "evidence" along the way to invoke jeopardy assessment against Stingray. The manner in which the State of New Jersey acted is commonly defined as extortion. Fortunately, I have never been the victim of a crime in my life. But, that day in July, I believe I was strong-armed by a state of the United States of America. Under the theory that nexus existed, I and my company were treated like someone on the run from the law. This entire episode was an unbelievable manner in which to conduct business.

Since that day, we have paid almost double the original amount that Stingray "owed" in interest and taxes.

V. Conclusion

I thank the Chairwoman and Members of the Subcommittee for considering this written statement. I believe that the small businesses of America are well served by the Committee's attention to these issues so important to our survival and future business in America.

I am sure each state within the United States has reason for "interpreting" P.L. 86-272. Unfortunately for small business, the end result is confusion, unexpected costs, another "hat" for small business owners to wear and as testified above a restriction to interstate commerce. I urgently ask the Subcommittee to clarify

P.L. 86-272 to eliminate unwarranted time and cost burdens placed upon small businesses and that the committee of jurisdiction, pass much needed legislation recently introduced by Congressmen Rick Boucher and Bob Goodlatte.

Prepared Statement of

Joseph Henchman, Tax Counsel,

Tax Foundation

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

June 24, 2008

Hearing on
H.R. 5267, the Business Activity
Tax Simplification Act of 2008

Madam Chairwoman, Ranking Member Cannon and members of the Committee:

On behalf of the Tax Foundation, I appreciate the opportunity to submit this statement of testimony regarding H.R. 5267, the Business Activity Tax Simplification Act of 2008.

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers about sound tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of neutrality, simplicity, transparency, and stability. We aim to make information about government finance understandable, such as with our annual calculation of "Tax Freedom Day," the day of the year when taxpayers have earned enough to pay for the nation's tax burden and begin earning for themselves.

While we, as an institution, take no position on the bill itself, we believe that retaining a physical presence nexus standard for state taxation of business activity is an essential part of a neutral, simple, transparent, and stable tax system. State efforts to move away from a physical presence standard undermine these principles and threaten to do long-term harm to economic growth.

In 2007, Americans spent $175 billion in online retail transactions, up 21 percent from the year before and accounting for six percent of total sales.[1] Although the proportion is still small, it is growing quickly.

Economic transformation and integration have always been features of the American economy, even back to the period of the Founding. Similarly, it is not new for states to seek revenues by shifting tax burdens away from the majority of voting residents, such as with changing nexus rules. Because economic integration is greater now than it has ever been before, the economic costs of nexus uncertainty are also greater today and can ripple through the economy much more quickly.

For example, if a New York company sells a product on its website to a California purchaser via servers in Ohio and Colorado, is the transaction everywhere, nowhere, or always somewhere at a given point in time? A physical presence rule provides an easy and logical answer to where the transaction is located, identical to the answer given for brick-and-mortar businesses: New York, where the company's property and payroll are located.

Proponents of economic nexus are mostly unanimous in rejecting that choice, but they would substitute only uncertainty about the ultimate answer. Inflicting this uncertainty on our economy, as states have begun doing in absence of a uniform physical presence standard, would be disastrous.[2] As long as state tax systems are defined by geographical lines, consistency requires that taxes be imposed only on individuals and businesses within those geographical lines.

Our written testimony makes two broad points. First, the physical presence standard limits destructive and likely unconstitutional state efforts to export tax burdens, efforts that stifle interstate commerce and harm economic growth. Second, a uniform physical presence standard would decrease transaction costs for interstate commerce, especially small businesses using mail and the Internet.

A Uniform Physical Presence Standard Limits Destructive and Likely Unconstitutional State Efforts to Export Tax Burdens

The U.S. Constitution came about in large part because the federal government initially had no power to stop states from setting up trade barriers between each other. Many states sought, as they do today, to protect domestic enterprises by burdening or discouraging out-of-state competitors with heavy taxes and import restrictions, harming these businesses and the economy as a whole. This race-to-the-bottom directly led to granting Congress the power to regulate interstate commerce.[3]

State officials still have every incentive to pursue *beggar-thy-neighbor* tax policies designed to shift tax burdens from voting in-state residents to out-of-state residents and businesses unable to resort to the ballot box. Not only does democracy not prevent harmful tax exporting from occurring, it actually worsens it, since services can be provided to a majority of voters, paid for by non-voters. As scholar Daniel Shaviro put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[4] The Supreme Court, using its dormant commerce clause jurisprudence, has intervened to stop some of the more egregious state actions; but its scope and power in this regard is limited.[5] It is thus up to Congress to exercise its power to protect interstate commerce.

The Tax Foundation has catalogued the growth in state tax exporting. Increasingly, states have imposed higher, non-neutral taxes on products and services more likely to be used by non-residents, such as hotel rooms and rental cars; they have enacted subsidies and tax credits to favored in-state activities but not out-of-state activities; and they have shifted corporate tax burdens by changing apportionment and nexus rules. States are trying to tax whatever they can reach—hardly a new or innovative development.

Contrary to the assertions of the Streamlined Sales Tax Project and others, states are moving away from harmonization. Beginning in 1959, for example, states adopted uniform rules for apportioning income earned by interstate corporations between states for tax purposes. The apportionment formula was one-third based on the location of property, one-third on the location of payroll, and one-third on the location of sales. Many interstate businesses, of course, conduct sales in more states than they have property and employees, and states with poorer business tax climates began to insist that sales count for more than a

third of the apportionment formula. Today, only 14 states still have an evenly weighted three-factor formula, with other states having moved to double weighting sales or even only counting sales. As these states reached out for a larger share of taxes that would otherwise go to other states, they reduced neutrality in the tax system, burdened interstate transactions with uncertainty, increased compliance costs, and threatened multiple taxation of the same business income by different states.

A recent nexus case involved West Virginia's levy of a quarter million dollars in state taxes on a company (MBNA, now FIA Card Services) whose only connection to West Virginia is that some of its customers now live there.[6] Although MBNA had property and 28,000 employees around the world, none of them were in West Virginia. And although a quarter million dollars may not be considered much for a company with profits of over $1 billion per year, MBNA had tax liability on those profits in the state where its employees and property were: Delaware. If every state were to impose similar taxes on every company, the negative impact on the economy would be serious.

A business with property and employees in a state is properly subject to state taxation, as the Supreme Court emphasized in its famous *Complete Auto Transit* case in 1977.[7] Known as the "benefit principle," liability to state taxation is usually described as a form of payment for enjoying police protection, access to courts, and state-maintained roads. This idea, that a company pays taxes in return for benefits derived from being physically present in a state, is reflected in the test adopted in *Complete Auto*, which requires that "the tax must be fairly related to services provided to the taxpayer by the state," as well as requiring that there must be "a sufficient connection between the taxpayer and the state."[8]

Proponents of economic nexus argue that out-of-state businesses be subject to tax since their sales into the state enjoy the benefit of a functioning economy. If a business does not have property or payroll in a state, true application of the benefit principle makes these arguments less compelling. Sales over the Internet or through the mail that happen to pass through a state, or terminate in a state, do not use state services to the extent of physically present companies and in-state residents, if they do at all.

At some point states must accept that the benefit of a functioning economy, which results in large part from good property rights and court systems, accrues primarily to in-state residents and businesses, and it is ultimately their responsibility to maintain and finance. (States are also unlikely to waive taxes on out-of-state residents when the economy is functioning poorly.) To allow interstate transactions to be nickel-and-dimed by state taxing authorities as they make their way across the continent would impose, and has imposed, a huge burden on interstate commerce.

In *Quill v. North Dakota* (1992), the U.S. Supreme Court reaffirmed the rule that a state cannot impose tax collection obligations on a business unless that business is physically present in the state.[9] The Court broadly recognized that states seek to impose greater tax burdens on businesses not physically present in the state, which by definition are taxes on activity occurring out-of-state. The only way to ensure that states are not burdening activity out-of-state more than activity in-state is to limit state tax collections solely to businesses with a physical presence.

A Uniform Physical Presence Standard Would Decrease Transaction Costs for Interstate Business Activity

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

We here at the Tax Foundation track the myriad rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state tax codes. The federal income tax code in 2006 stood at 7 million words in 236 code sections, up from 718,000 words in 103 code sections in 1955. In 2005, the estimated time and money cost of complying with the federal income tax code was 6 billion man-hours, worth $265 billion.[10]

Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. These costs are especially relevant for interstate businesses, both large and small. In the United States, there are over 7,400 sales-taxing jurisdictions, many with their own tax rates, tax bases, and lists of exemptions. The Streamlined Sales Tax Project has been making little progress in its effort to align sales tax jurisdiction boundaries with 9-digit zip codes (of which there are 38,547,080), and it has no intention of trying 5-digit zip codes.[11] So even if an Internet retailer knows the nine-digit zip code of his customer, that doesn't mean he or she will know the correct tax rate.

Retailers are stuck between a rock and a hard place. If they "play it safe" and end up overcharging the customer on sales tax, they are subject to a class action lawsuit. If they undercharge, they are subject to tax penalties and prosecution by the state. Here at the Tax Foundation, we have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for retailers who are in business to sell a good or service, not to conduct tax policy research.

Under either physical presence or economic nexus, brick-and-mortar stores need to worry only about the tax system where they are physically present. The same would be the case for online retailers under a physical presence standard. But under an economic nexus standard, online retailers would have to pay taxes based on where their *customers* are located. This would burden e-commerce more than brick-and-mortar business, and effectively impose an exit toll on outbound commerce.

I live in Virginia but work in the District of Columbia. Say I go down the street to buy lunch from a retailer here in the District. The retailer earns money and ultimately pays income tax on the revenue to D.C., which makes sense since that's where the retailer's property and employees are. Under economic nexus, however, the retailer would have to pay income taxes on earnings from the sale to me based on where I live—in this case, Virginia—with the money going to Virginia. Income taxes derived from each transaction would go to a different state, based on where the customer lives. This real-world application of economic nexus demonstrates that besides the compliance problems, the complexity, and the administrative burden, economic nexus just doesn't make sense. Under the benefit principle, D.C. should get this money, not Virginia.

There is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard. Under physical presence, only one state may claim a certain share of business income at a time. It's easy to do—one just looks to see where employees and property are.

An economic nexus rule, by contrast, complicates matters. In the *MBNA* case, West Virginia sought to tax income that is already subject to Delaware taxation. Even though *Complete Auto* says that a state cannot tax beyond its fair share, multiple states would assert that they are entitled to tax the income. States are unlikely to smooth out such agreements for the same reason that rules for divvying up state corporate income have become less uniform. Without a uniform standard, multiple taxation and substantial litigation surrounding it could arise.

States' adoption of economic nexus also raises questions of temporal limitations. How far in space and time does economic nexus go? States vary widely on how long nexus lasts after in-state activity occurs: three states say twelve months, the State of Washington says five years, two states say it ends on the day the physical presence ends, and in Indiana, nexus apparently lasts forever.[12] Only a uniform federal standard can provide a rational and comprehensive answer to the question of how far is too far and how long is too long.

These problems—tracking state tax rates and bases in 7,400+ jurisdictions, litigation, inequity, multiple taxation, and unpredictability—are associated with economic nexus. A uniform physical presence standard would avoid most or even all of them.

Conclusion

The Internet has seen an increased amount of commerce, but some seem to view it as a golden goose that can be squeezed without adverse effects on economic growth. It must be understood that the availability of many items in electronic commerce could be hindered if states are permitted to adopt economic nexus standards. States will reach for as much revenue as they can, if they believe that it can benefit them even at the expense of other states and the nation as a whole. A uniform physical presence standard would restrain these efforts, maintain a level playing field for all types of businesses, and reduce costs and burdens to interstate commerce.

The Supreme Court is not well-equipped to move beyond the broad outlines of its past Commerce Clause cases. Courts can only develop doctrine in a case-by-case fashion, based on the facts of the particular case before it. (Additionally, the Court seems to have an aversion to tax cases.) Congress, by contrast, can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. This is why congressional action, which can be more comprehensive and accountable than judicial action, and can also better address issues of transition, retroactivity, and *de minimis* exemptions, may now be the best vehicle for preventing burdens to interstate commerce by adopting a uniform physical presence standard. It is thus up to Congress to exercise its power to protect interstate commerce.

We now live in a world with iPods and Amazon.com. It is a testament to the Framers that their warnings about the incentives for states to hinder the national economy remain true today. Some academics argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to apply them to new circumstances, the idea that parochial state interests should be prevented from burdening interstate commerce remains a timeless principle regardless of how sophisticated technology may be.

Endnotes

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[1] *See* "Online Sales Spike 19 Percent," CNN (May 14, 2007), available at http://tinyurl.com/2ox935.

[2] Replacing a physical presence standard with a "modern" one has caused uncertainty and economic dislocation before. *See* Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, STATE TAX NOTES (Nov. 5, 2007), available at http://tinyurl.com/5jsykb.

[3] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. 1, 224 (opinion of Johnson, J.) ("[States,] guided by inexperience and jealousy, began to show itself in iniquitous laws and impolitic measures . . ., destructive to the harmony of the States, and fatal to their commercial interests abroad. This was the immediate cause that led to the forming of a convention.").

[4] Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

[5] For a discussion of past cases, see Joseph Henchman, *Defending Competitive Neutrality Before the Supreme Court*, TAX FOUNDATION SPECIAL REP. NO. 158 (Nov. 2007).

[6] *See Tax Comm'r of State v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, 75 U.S.L.W. 3676 (U.S. Jun. 18, 2007) (No. 06-1228).

[7] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

[8] *Id.* at 279.

[9] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[10] *See* Scott A. Hodge, J. Scott Moody & Wendy P. Warcholik, *The Rising of Complying with the Federal Income Tax*, TAX FOUNDATION SPECIAL REPORT NO. 138 (Jan. 2006).

[11] *See* Douglas L. Lindholm, *"Old Economy" Tax Systems On A "New Economy" Stage: The Continuing Vitality of the "Physical Presence" Nexus Requirement*, COUNCIL ON STATE TAXATION (Feb. 27, 2003), at 20-26, available at http://tinyurl.com/59v6yw.

[12] *See* H. Beau Beaz III, *The Rush to the Goblin Market: The Blurring of* Quill*'s Two Nexus Tests*, 29 SEATTLE U. L. REV. 581, 622 (2006).

MARJORIE GELL

June 20, 2008

The Honorable John Conyers, Jr.
House Judiciary Committee
United States House of Representatives
Washington, DC 20515

Re: Hearing on H.R. 5267 (the Business Activity Tax Simplification Act of 2008)

Dear Sir:

I am writing to express my support of H.R. 5267 (the Business Activity Tax Simplification Act of 2008), and to ask that you please submit the attached law review article into the record for the hearing on this bill scheduled for June 24, 2008. My article, entitled *Broken Silence: Congressional Inaction, Judicial Reaction, and the Need for a Federally Mandated Physical Presence Standard for State Business Activity Taxes*, has been accepted for publication in the *Pittsburgh Tax Review* (forthcoming Spring 2009).

As my article suggests, I believe that it is imperative that Congress act to resolve the serious and longstanding question of what jurisdictional standard a state should apply in order to impose a business activity tax on an out-of-state entity with no in-state physical presence. The untenable patchwork of standards, in which some state taxing authorities are permitted to tax out-of-state entities that lack physical presence and others are not, has led to the a situation in which no business can predict whether and where its commercial activities will subject it to state taxation. The lack of a clear standard directly burdens and disrupts the free flow of interstate commerce that the Commerce Clause exists to protect, and creates impediments to the creation of a strong and unified national market.

My article also addresses the proposals that have made by various groups for the adoption of an economic presence standard. For reasons outlined in my article, the imposition of anything less than a purely physical presence standard would create further havoc in the already contentious world of state taxation of business activity. That disruption will necessarily intensify until Congress clarifies and enacts a physical presence rule applying to all state taxes.

Respectfully submitted,

Marjorie Gell
Asssistant Professor

Testimony of Mr. Stephen Joost, Firehouse Restaurant Group, Jacksonville, Florida

Members of Congress, Ladies and Gentlemen

Thank you for allowing me to testify before your committee today. My name is Stephen Joost. I am the Chief Financial Officer and Principle in Firehouse Restaurant Group, Inc. otherwise known as Firehouse Subs. Firehouse Subs is an emerging national chain of sandwich shops. Currently we have 312 restaurants operating from Las Vegas Nevada to Washington D.C. We started in Jacksonville Florida 13 years ago. Through our franchising efforts we employee over 5,000 people and have achieved national sales of over $200 million. Firehouse Subs has helped numerous employees, franchisees and area representatives achieve their American Dream and yes, some have become very wealthy. On the national level, franchising has also made a tremendous impact on the economy and the entrepreneurial spirit of Americans. According to a 2008 International Franchise Association Educational Foundation study conducted by PricewaterhouseCoopers, there are 909,000 franchised businesses in the United States, employing 21 million workers (directly and indirectly), responsible for $2.3 trillion in annual economic output.

However, during that time, we have come across some serious impediments and challenges to our growth. There are always the usual impediments to growing a business such as competitors coming out with a better product, access to capital, real estate locations, paying competitive wages…etc. However, there have been several artificial barriers, complexities and tax traps created by Government that have hurt my business over the years that have led to unwarranted expenses and wasted money. I am here today to help explain what myself and my company have been through and to add suggestions as to how you can help.

One of the more perplexing problems facing a growing business is interstate commerce. With our system of federal government and independent states, each state is allowed to create its own laws.

This has led to the implementation of many different laws with many different standards. Examples are differing disclosure requirements in our disclosure documents, differing sales tax methods and rates, and differing income tax laws and application thereof to name just a few. These differing laws and standards upon which they are applied have necessitated my company to hire a plethora of tax accountants and lawyers to help us comply with the regulations, file the various tax returns and documents each state requires, and to help us employ various strategies to limit our liabilities. Sometimes I wonder what business I am in.

One of the more disturbing problems created by state governments is that of state income taxes and franchise taxes. As economic growth has slowed, so has state revenue growth. According to Allison Grinnell of the Rockefeller Institute, state tax revenue totaled $147 billion in the third quarter of 2007 — a 4.4 percent increase over the 3rd quarter of 2006. However, when adjusted for legislated tax changes and inflation, total state tax revenue declined by 0.6 percent. Therefore, many states are looking for money. One of the ways they do this is through state income taxes and by taxing corporations who are not located in their state through a mechanism called nexus.

In its simplest form, Nexus means a connection. Certain activities, as insignificant as they may seem, may establish nexus (a connection with a state that subjects you to its tax laws). A company may have unknowingly had nexus with a state for many years. It might even be responsible for back sales tax, franchise tax and/or income taxes, penalty and interest for past years. Examples of creating nexus, that an ordinary person would not think of are having a sales representative solicit business in a state, traveling for a meeting with franchisees in a state, traveling to inspect a store, even the mere solicitation of business in a state without having ever entered the state can trigger nexus rules.

Worse yet, the nexus standards between states vary widely, and wildly. Furthermore, the nexus standards within a state can also vary depending on what tax is being imposed. For example the nexus standards for franchise taxes can be much broader than they are for income taxes. This means that companies that could be exempt from paying income taxes in a certain state may have a franchise tax liability if they do business in that state depending on how that state defines nexus.
Furthermore, since each state has its own departments of revenue, interpretations on how the laws are applied can change.

Once a nexus is established, states also get into the game of apportionment. Apportionment is a formula to figure out how much income is attributable to a specific state's income tax. These apportionment rules are often changed by the individual states to help them garner an advantage over other states.

Currently, my view on the subject matter is the way states are imposing burdensome rules, and changing them every year is, first it is an unfair tax on intellectual property and secondly it has created a subsidy for lawyers and accountants. The fact that the whole Firehouse Subs concept was created in Jacksonville Florida and the fact that franchisees pay us a royalty for the use of our name, our products, our training and methods of operation should not involve other states. All the intellectual property, trademarks, and business practices were created in Jacksonville. When people pay us for the use of this property, that is the essence of franchising. I have not heard of other states taxing the real physical property of other states and yet while intellectual property can not necessarily be consumed or touched, it is none the less of the same and sometimes more value than real physical property.

I believe these rules more specifically have created an unintended attack on the franchise business. While I know I am not, nor my company is opposed to paying taxes, we are opposed to having to

spend hundreds of thousands of dollars to figure out how to do it because we have to hire an army of accountants and lawyers to do it. What is needed, and what I would recommend is a single set of rules defining what constitutes nexus and how it will be applied in the 50 states. More importantly, nexus should be defined in a more conservative and common sense way than is being commonly applied today. The fact that if I merely step foot in a state creates a taxing event is incredulous. Even at the end of the day, if I did not agree with your definition of nexus, that fact that there was one standard applied across the country would be a great relief to myself, my company and to the franchise world.

Thank you for hearing me out today. I hope my testimony has helped shed some light on this very important topic. If you have any questions I will be happy to answer them.

Statement of the U.S. Chamber of Commerce

ON: H.R. 5267, BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2008

TO: SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW OF THE HOUSE JUDICIARY COMMITTEE

DATE: JUNE 24, 2008

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 105 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Statement for the record on
Business Activity Tax Hearing
before the
SUBCOMMITTEE ON COMMERCIAL AND ADMINSTRATIVE LAW OF THE HOUSE JUDICIARY COMMITTEE
on behalf of the
U.S. CHAMBER OF COMMERCE
June 24, 2008

Chairwoman Sánchez, Ranking Member Cannon, and members of the Subcommittee, the U.S. Chamber of Commerce thanks you for the opportunity to comment on H.R. 5267, the "Business Activity Tax Simplification Act of 2008." The Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies also are active members. The Chamber is particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

H.R. 5267 would establish a bright-line, physical presence nexus standard for when a state can levy a tax on business activity on an out-of-state business. The Chamber strongly supports H.R. 5267, the Business Activity Tax Simplification Act of 2008.

BACKGROUND

The income of a multi-state business generally is subject to tax in those states where the business has a physical presence, such as an office or employees. However, some states have asserted that a business is subject to tax when it has an economic presence. Under this economic presence standard, states require businesses to pay tax not only where the business has offices or employees, but also where the business, regardless of physical presence, has sales, advertises, or otherwise derives income.

H.R. 5267 would provide a bright-line, physical presence standard for when a state can levy a tax on business activity on an out-of-state business. Further, H.R. 5267 would provide predictability and certainty to businesses as to what their 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 U.S. Constitution, Congress is responsible for ensuring 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 this constitutional standard only if an out-of-state corporation has "substantial nexus" with the taxing state.[1] The U.S. Supreme Court, in Quill Corp. v. North Dakota,[2] a case involving sales and use tax collection, held that a state could not levy taxes on an out-of-state business unless that business has a "substantial nexus" within the taxing state.

Different states have interpreted the Quill decision in different manners. These different interpretations have resulted in states having different presence standards, based on both the type of tax imposed and the kind of industry being taxed.

For example, some states argue that the Quill decision is limited to sales tax. These states require a physical presence to levy a sales tax as mandated by Quill, but levy all other business taxes based an economic presence standard. The result is differing presence standards based on the type of tax imposed.

Likewise, states also impose different taxes based on the kind of industry being taxed. This is because Public Law 86-272 prevents a state from imposing an income tax on income derived within the state from interstate commerce, if the only business activity within the state is the solicitation of orders for tangible personal property, provided that the orders are approved and filled outside the state. Thus, the physical presence standard would control in the case of businesses which produce tangible goods. Conversely, businesses which provide services or other non-tangible products are not explicitly protected under Public Law 86-272. Thus, this results in differing presence standards for different industries.

The disparities in tax treatment that arise under current law lead to uncertainty and unpredictability for businesses. These uncertainties can result in litigation to settle tax disputes which is costly to both the taxpayers and state governments.

PROVISIONS OF H.R. 5267

Physical Presence Standard

H.R. 5267 would codify the physical presence standard, 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, has tangible or real property, or uses agents to

[1] U.S. Constitution, Article I, Section 8, Clause 3.
[2] 504 U.S. 298 (1992).

perform certain activities within a taxing state.

Since H.R. 5267 provides that a *de minimis* physical presence would not give rise to meeting the physical presence standard, it would allow a business to send employees into a state for 15 days in any year and not subject that business to an obligation for that state's income tax. Further, under the *de minimis* rule, H.R. 5267 would allow employees to perform transitory assignments and not trigger unintended tax obligations.

These rules would provide both a clear physical presence standard and a clear standard for what activities a firm can conduct within a state that will not trigger that state's taxing power. This would provide certainty to businesses and tax administrators and would reduce compliance and enforcement costs.

Modernization of Public Law 86-272

Public Law 86-272 was enacted 49 years ago. Since then, the U.S. economy has seen significant changes. Recognizing the changes in both the services and products offered as well as the types of companies that make up our economy, H.R. 5267 would extend the longstanding protections of Public Law 86-272 to all sales or transactions, not just to sales of tangible personal property.

H.R. 5267 also would modernize 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. H.R. 5267 would ensure that Public Law 86-272 covers all business activity taxes, not just net income taxes.

CONCLUSION

The Chamber strongly supports H.R. 5267. By codifying the physical presence standard, H.R. 5267 would provide certainty to both businesses and tax administrators about when taxes can be levied, reducing compliance and enforcement costs. Further, by modernizing Public Law 86-272, H.R. 5267 would treat services and products offered by all businesses in a more fair and equitable manner.

Chairwoman Sánchez, Ranking Member Cannon, and members of the Subcommittee, the Chamber applauds your leadership in conducting this hearing and thanks you for the opportunity to comment on this issue.

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