STATE TAXATION: THE ROLE OF CONGRESS IN DEFINING NEXUS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

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HOUSE OF REPRESENTATIVES

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STATE TAXATION: THE ROLE OF CONGRESS IN DEFINING NEXUS

THURSDAY, FEBRUARY 4, 2010

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

The Subcommittee met, pursuant to notice, at 11:43 a.m., in room 2141, Rayburn House Office Building, the Honorable Steve Cohen (Chairman of the Subcommittee) presiding.

Present: Representatives Cohen, Watt, Lofgren, Johnson, Scott, Chu, Franks, Jordan, Coble, and King.

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

Mr. COHEN. 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 and apologizes for being a few minutes late.

I will now recognize myself for a short statement.

Currently, States levy a tax on income earned or on a transaction occurring within its borders. The taxpayer is liable only if there exists a nexus or a connection between the State and the activities of the taxpayer.

Some taxpayers have expressed concerns that current State tax policies are difficult to navigate, leading to unpredictable tax bills or incurring onerous paperwork. They contend that States utilize an overly broad tax nexus standard to impose unnecessary taxes and urge Congress to step in and define State tax nexus.

State government representatives disagree. They contend the State taxes in accordance with the taxpayers's use. States—the redefining of nexus would unfairly preempt States' authority to tax and very likely lead to a substantial loss of State tax revenue.

In response to the confusion, many legislative proposals have been introduced to clarify the nexus requirements. These proposals now before the Committee seek to limit or expand the ability of States to impose certain taxes.

One such proposal urges Congress to grant States the authority to collect and remit use taxes from those with whom the States currently do not have a sufficient nexus.

Another proposal would prohibit a State from taxing the income of a taxpayer who has not established a physical presence within the State. Essentially, these and many other proposals attempt to establish or solidify what constitutes a sufficient nexus.

Before determining what constitutes that sufficient nexus for State tax purposes, Congress should ensure that it understands how defining nexus would affect State revenues.

Additionally, we must consider how defining nexus would affect business development and investments. And we must explore how clarifying nexus would impact individual taxpayers.

Today's hearing should help us understand the implications of defining nexus. The hearing will also provide Subcommittee Members the opportunity to examine generally how the legislative proposals would impact State taxation.

So it is your classic situation of States wanting and needing more revenue and desiring their province and control and taxing to support their services, and businesses not wanting to be interfered with and having that difficulty of having interstate commerce and having less government intrusion. It is your classic situation.

With that, I thank the witnesses for appearing today, and I look forward to their testimony.

I now recognize my colleague, Mr. Franks, the distinguished Ranking Member of the Subcommittee, for his opening remarks.

Mr. Franks?

Mr. FRANKS. Well, thank you, Mr. Chairman.

Mr. Chairman, today's hearing is sort of an anomaly for this Subcommittee. You know, rather than discussing a particular bill and how it would impact this industry or that State, we are discussing the constitutional limitations on States' ability to tax, and it is a question that I am obviously interested in, having been the former Ranking Member of Constitution Committee.

And so before I start, I have several statements from various business groups that I would, with your permission, Mr. Chairman, like to see inserted into the record.

Mr. COHEN. Without objection.

[The information referred to follows:]

NATIONAL FOREIGN TRADE COUNCIL, INC.

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Comments of the National Foreign Trade Council
On the Business Activity Simplification Act (H.R.1083)
Before the House Judiciary Commercial and Administrative Law Subcommittee
On February 4, 2010

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. 1083, the Business Activity Tax Simplification Act, ("BATSA"), and respectfully asks that you support the bill and schedule it for a markup.

H.R. 1083, a bill introduced 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.

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A Uniform Physical Presence Standard Would Limit Destructive State Efforts to Export Tax Burdens

By Joseph Henchman
Tax Counsel, Tax Foundation

Hearing on H.R. 1083, the Business Activity Tax Simplification Act
Before the Subcommittee on Commercial & Administrative Law,
Committee on the Judiciary, U.S. House of Representatives

February 4, 2010

Mr. Chairman, Ranking Member Franks, and members of the Committee:

With online retail transactions accounting for a significant and growing share of total sales, the importance of preserving the free flow of interstate commerce grows as well.

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 a logical answer to where the transaction is located, identical to the answer given for brick-and-mortar businesses: in this case, 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, has been disastrous.[1] 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. States are limited in their powers and this includes geographic limits to the power of taxation.

Key Findings

- 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.
- 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.
- Efforts to move away from the physical presence standard in taxation threaten to do long-term harm to economic growth and undermine the principles of sound tax policy: simplicity, neutrality, transparency, and stability.
- Congressional action to adopt a physical presence standard may be the best vehicle for preventing burdens to interstate commerce, because it can be more comprehensive and accountable than judicial action and can also better address issues of transition, retroactivity, and *de minimis* exemptions.

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.[2]

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."[3] 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.[4] 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 individuals, goods, and services more likely to be used by non-residents. Our research has reviewed such taxes on visiting athletes, businesses engaged in interstate commerce, and hotel rooms and rental cars. States have also enacted subsidies and tax credits only available to favored in-state activities, and have shifted corporate tax burdens by changing apportionment and nexus rules.

As these states have reached beyond their borders for a larger share of taxes that would otherwise go to other states, they have 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.[5] 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.[6] Known to economists as the "benefit principle," liability to state taxation is usually described as a form of proxy 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."[7]

Opponents of physical presence nexus argue that out-of-state businesses must be subject to income and sales 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.

Such services are used primarily, if not exclusively, by in-state residents and it should be their responsibility to finance. 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 sales tax collection obligations on a business unless that business is physically present in the state.[8] The Court broadly recognized that states seek to impose greater tax burdens on businesses that are not physically present, 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 of all kinds 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 numerous rates, bases, exemptions, credits, adjustments, phaseouts, exclusions, and deductions that litter our federal and state tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden.

We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes to the many taxes in our country, but even we have trouble doing it. It would be extremely difficult for 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, out-of-state and online businesses would have to pay income and sales 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.

There is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard. That would not occur under a physical presence standard because 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.[9] 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 8,000+ jurisdictions, litigation, inequity, multiple taxation, and unpredictability—are associated with economic nexus. A uniform physical presence standard for all forms of taxation would avoid many of these problems.

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.

Congress can obtain evidence from interested stakeholders and take political and economic factors into consideration when developing new rules of taxation. The Supreme Court, by contrast, must develop broad doctrine in a case-by-case fashion, based on the facts of the particular case before them. (Additionally, the Court seems to have an aversion to tax cases.)

This is why congressional action, which can be more comprehensive and accountable than judicial action, and can better address issues of transition, retroactivity, and *de minimis* exemptions, may now be the best vehicle for preventing burdens to interstate commerce by adopting a uniform physical presence standard. It is up to Congress to exercise its power to protect interstate commerce.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today.

Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.

Notes

1. 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://ricxud.com/5isykb.

2. *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.").

3. Daniel Shaviro, "An Economic and Political Look at Federalism in Taxation," 90 Mich. L. Rev. 895, 957 (1992).

4. For a discussion of past cases, see Joseph Henchman, *Defending Competitive Neutrality Before the Supreme Court*, Tax Foundation Special Rep. No. 158 (Nov. 2007).

5. *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).

6. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

7. *Id.* at 279.

8. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

9. *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).

About the Tax Foundation

The Tax Foundation is a non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation seeks to make information about government finance more understandable, such as with the 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.

About the Center for Legal Reform at the Tax Foundation

The Tax Foundation's Center for Legal Reform educates the legal community and the general public about economics and principled tax policy. The Center's research efforts focus on the scope of taxing authority, the definition of tax, economic incidence, and taxpayer protections.

COALITION FOR RATIONAL AND FAIR TAXATION

February 4, 2010

The Honorable Steve Cohen., Chairman
The Honorable Trent Franks, 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 State Tax Nexus Issues

Dear Chairman Cohen and Ranking Member Franks:

Thank you for the opportunity to submit this statement for the record for the February 4, 2010 hearing on State Tax Nexus Issues 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 the business activity tax simplification act ("BATSA"), most recently introduced as the Business Activity Tax Simplification Act of 2009, H.R. 1083, is the appropriate standard for state and local taxation of out-of-state businesses. Further, CRAFT believes that the modernization of Public Law 86-272, as BATSA would accomplish, is essential for the health and growth of the American economy. Therefore, CRAFT strongly supports BATSA and respectfully urges the approval of this legislation for consideration by the full Congress and ultimate enactment. CRAFT believes that it is essential for Congress to provide clear guidance to the states in the area of state taxing jurisdiction, remove the drag that the current climate of uncertainty and unpredictability places on American businesses, and thereby protect American jobs and enhance the American economy.

I. BACKGROUND

The principal motivation for the adoption of the United States Constitution as a replacement to the Articles of Confederation was a desire to establish and ensure the maintenance of a single, integrated, robust American economy. This is reflected in the

Commerce Clause, which provides Congress with the authority to safeguard the free flow of interstate commerce. Enacting legislation regarding states and localities imposing, regulating, or removing tax burdens placed on transactions in interstate commerce is not only within Congress' realm of authority, it is also – we respectfully submit – Congress' responsibility. 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] BATSA is designed to address the issue of when a state should have authority to impose a direct tax on a business that has no or only a minimal connection to the state. 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. BATSA applies to state and local business activity taxes, which are direct taxes that are imposed on businesses engaged in interstate commerce, such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes. BATSA does not apply to other taxes, like personal income

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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, BATSA ensures that the economic burden of state tax impositions is appropriately borne only by those businesses that receive such benefits and protection from the taxing state and ensures that businesses pay these taxes only to those states and localities where they have earned income. BATSA 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, BATSA's physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners. 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 BATSA 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

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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); *Capital One Bank v. Mass. Comm'r of Rev.*, 899 N.E.2d 76 (Mass. 2009), *cert denied* 2009 U.S. LEXIS 4616 (2009); *Geoffrey, Inc. v. Mass. Comm'r of Rev.*, 899 N.E.2d 87 (Mass. 2009), *cert denied* 2009 U.S. LEXIS 4584 (2009).

[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).

general benefits and protections. Proponents of an economic nexus standard also argue that states have spent significant amounts of revenue to maintain an infrastructure for interstate commerce 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. BATSA PROVIDES AN APPROPRIATE SOLUTION

A. *PROVISIONS OF BATSA*

1. CODIFICATION OF THE PHYSICAL PRESENCE STANDARD

BATSA 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, BATSA 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, BATSA provides that presence in a state to conduct limited or transient activities will not be considered in determining whether a business has the requisite physical presence in the jurisdiction. 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.

BATSA 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, BATSA 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, BATSA 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.

BATSA 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 BATSA and Public Law 86-272 are two separate constraints on state taxation of interstate commerce and each law operates independently of the other. Thus, any activities protected by Public Law 86-272, as modernized by BATSA, will not create a physical presence for that business, regardless of whether the protected activities occur in the taxing jurisdiction for more than 15 days.

Ohio CAT and Texas Margin Tax indicate that states are increasingly considering enacting non-income-based business activity taxes.[24]

BATSA 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 BATSA, 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 BATSA, 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 BATSA is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Due Process Clause and the Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus" between the taxing state and the putative taxpayer, whereas the Due Process Clause requires only

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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").

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 principled reason for there to be any lower of a standard for business activity taxes than for sales

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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).

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 measures are too restrictive and violate principles of federalism.[35] No one disagrees that tension

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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).

[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.

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]

BATSA simply codifies the traditional jurisdictional standards for when a state or local government may impose a tax on a business engaged in interstate commerce; 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. BATSA merely confirms that the ability of states to tax is subject to constitutional limitations. Thus, BATSA strikes the correct balance between state autonomy/sovereignty and interstate commerce.

B. *Effect on International Taxation and American Competitiveness*

Our country's own history and the federal government's position in the context of international taxation provide a strong reason to establish a physical presence nexus standard. Specifically, a physical presence nexus standard would promote consistency between international tax and state tax jurisdictional standards.

For over 80 years, the United States, along with most other countries in the world, has adopted and implemented a so-called "permanent establishment" standard in its income tax treaties with foreign jurisdictions. This "permanent establishment" standard is derived from the Model Tax Convention of the Organisation for Economic Co-operation and Development ("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 company's income ("source country").[39] Under the terms of the OECD Model Tax Convention,

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[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).

[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.

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 BATSA's physical presence nexus standard consistent conceptually with the OECD "permanent establishment" jurisdictional standard, but BATSA's physical presence standard accomplishes the same policy goals by providing a bright-line standard that is clear and equitable.[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.

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

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[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).

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 BATSA, 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 BATSA

A. *EFFECT ON STATE REVENUES*

There is no basis for the assertion that BATSA 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 BATSA bill projected that the nationwide revenue 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

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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).

local taxes paid by businesses in 2005.[46] Although a study conducted by the Congressional Budget Office ("CBO") of the 2005 version of BATSA 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 BATSA because many states do not currently impose income taxes on businesses lacking physical presence in the state.[48]

B. *NOT A TAX SHELTER VEHICLE*

BATSA neither encourages the use of abusive tax planning nor nullifies the ability of states to attack such shelters. Importantly, BATSA includes a specific provision ensuring that state governments retain all necessary weapons to fight what they perceive as inappropriate tax planning. Therefore, BATSA 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 time-tested and valid Congressional policy. Physical presence is also an accepted standard for

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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 physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.* at 16.

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. BATSA provides simple and identifiable standards that will significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government.[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 BATSA provides the most fair and equitable standard. This is true primarily because businesses have a reasonable expectation of taxation only when they are the recipients of meaningful benefits and protections provided by the taxing jurisdiction. Additionally, businesses should only pay tax to those jurisdictions where they earn income.

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 BATSA should therefore be enacted. But it is clear that BATSA warrants the full and enthusiastic support of the Subcommittee. BATSA will not cause any meaningful dislocations in any state's revenue sources and will not encourage mass tax sheltering activities. Instead, its enactment will ensure that the U.S. business community, and thus the American economy, are not unduly burdened by unfair attempts at taxation without representation.

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[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 BATSA will end all controversies concerning the state tax business activity tax nexus, any statute that adds nationwide clarification obviously reduces the amount of controversy and litigation by narrowing the areas of dispute. For example, in the nearly fifty years since its enactment, Public Law 86-272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense.

Sincerely,

Arthur R. Rosen
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340 Madison Avenue
New York, NY 10173
Counsel, Coalition for Rational and Fair Taxation

February 4, 2010

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. 1083, the Business Activity and Tax Simplification Act of 2010

Chairman Cohen, Ranking Member Franks, and members of the Committee:

On behalf of the California Taxpayers' Association, I submit this statement in support of H.R. 1083, the Business Activity and Tax Simplification Act of 2010.

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.

In addition to a lack of certainty regarding whether any particular state has sufficient nexus to impose tax on nonresident businesses, such variation creates a tremendous burden on interstate commerce by making businesses reluctant to engage in any activity that may subject them unwittingly to taxation in another state.

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.

As E-commerce proliferates, the inconsistent application of nexus rules is approaching chaotic. We respectfully urge you to act quickly to resolve this ever growing problem. On behalf of the California Taxpayers' Association, I respectfully request your support for H.R. 1083, which will contribute to economic growth and expansion as the economy continues to evolve.

Testimony of Ivan Petric, Vice-President
Hope Trucking, Inc.
15180 Copeland Way; Spring Hill, FL 34604-8130
Phone: 352-797-4906

Before the
The Honorable Stephen I. Cohen, Chairman
United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

February 4, 2010

Chairman Cohen and Members of the Committee: Thank you for the opportunity to provide testimony relevant to your hearing on State Taxation: The Role of Congress in Defining Nexus.

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 States of New Jersey, Kansas, Arkansas, and others where we have no physical presence. We need Congress to stop such unlawful state attempts to burden interstate commerce by enacting the Business Activity Tax Simplification Act of 2009 (H.R. 1083) ("BATSA"). The situation is getting worse as time passes without any Federal resolution of the problem, so I respectfully urge that the Committee act now by favorably reporting out BATSA.

· Why are we testifying

We are speaking up because thousands of small businesses throughout the United States are totally unaware of the potential risk of abuse in the taxation process. Over the past several 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.

Without strong Federal legislation to clarify that the Constitution limits state tax nexus over nonresident companies to those that have some physical presence in the taxing jurisdiction, all of these small businesses will soon be unable to participate freely in Interstate Commerce without fear of taxation reprisals.

We urge the Congress' support for a bill that will clarify a clear and reasonable physical presence nexus standard applicable to state taxation of nonresident companies. 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 beyond the proper jurisdictional reach of

their tax authority. BATSA seeks to ensure uniformity, as opposed to the crazy quilt of existing state and local tax nexus standards. This Congress should work together to enforce a Constitutional state tax nexus standard.

II. Background.

As a small business we incur substantial costs in our efforts to comply with state tax laws, especially in dealing with states where we are not physically located. We find that widely varying state business activity tax nexus standards make compliance very difficult. I would hope that Members of this Subcommittee would question whether forsaking long-standing constitutional nexus standards is the proper response to the greatly exaggerated, and largely self-correcting problem of lost tax revenue claimed by state tax officials.

Congress clearly knows that "no 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.

Without strong Federal legislation, small businesses will soon be unable to participate freely in Interstate Commerce without fear of taxation reprisals. 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 their supposed tax sovereignty, pitted against the desire to expand their taxing jurisdiction that makes any claims by the states that they can orchestrate their own version of state tax reform fatally flawed and doomed to fail in achieving any real simplification and uniformity.

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 judicial precedent 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 result in chaos with respect to both tax administration and compliance (involving fifty state governments, and more than 7,500 local taxing districts, imposing their vastly different tax regimes). Moreover, out-of-state companies 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 imposition of taxes, duties, tariffs, and other levies. 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 nonresident companies by constantly 'tweaking' legislation to avoid traditional physical presence nexus standards. For example, 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 issues, complicated by very conflicting and confusing guidance. This situation needs to be clarified and BATSA seeks to do just that.

Interstate business 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 tax nexus rules applied to small and large multi-state companies that do business across state lines only serves to chill interstate commerce. We believe the BATSA language will help to eliminate the current confusion and reduce the need for companies to engage in prolonged and costly litigation to resolve such tax enforcement discrepancies. BATSA will not diminish the states' ability to collect legally due tax revenue.

IV. Recent Taxation Nexus Experiences

In the past several years we have experienced several 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 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. 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[1], and New York, all of which assert nexus based on our trucks as property being driven within their jurisdictions.

V. 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

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1 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 be domiciled in Kansas or otherwise.

funds, much less to demand fair treatment from aggressive and abusive state tax collectors. We believe that BATSA will help clarify the physical presence nexus standard embodied in Public Law 86-272.

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[2]
Veteran, Disabled, Retired

[2] Mr. Petric has a BS Degree in Business Administration. He is an Honor and Distinguished Military Graduate of the Reserve Officers Training Corps, with numerous Distinguished Service Awards and Letters of Commendation.

Software Finance & Tax Executives Council

www.softwarefinance.org

BEFORE THE COMMITTEE ON THE JUDICIARY,

SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON STATE TAXATION:

THE ROLE OF CONGRESS IN DEFINING NEXUS

FEBRUARY 4, 2010

STATEMENT FOR THE RECORD

The Software Finance and Tax Executives Council (SoFTEC) thanks the Chairman and Ranking Member for the opportunity to submit this statement for the record on the Subcommittee's hearing on the role of Congress in defining "nexus." SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting. Many SoFTEC members provide their products and services to customers in multiple states and face the possibility of tax compliance burdens in states in which a revenue department might assert that they have "nexus." Because the concept of "nexus" is ill-defined, SoFTEC members face uncertainty over whether they have tax compliance burdens in states where they have no property or employees. Thus, SoFTEC has an interest in providing the Subcommittee with its perspective on Congress's role in defining "nexus."

What is Nexus:

"Nexus" generally is the jurisdictional predicate that must exist before a state is permitted to exert its taxing power over a nonresident taxpayer and is of constitutional dimension, finding its roots in the Due Process and Commerce Clauses. The Supreme Court, in its most recent "nexus" decision described Due Process "nexus" as follows:

> The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill v. North Dakota,* 504 U.S. 298, 306 (1992), quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954).

The Court in *Quill*, in discussing the Commerce Clause aspect of "nexus," went on to note that the Commerce Clause requires "a substantial nexus and a relationship between the tax and State

provided services," which "limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce." *Id* at 313.

Thus, in order for a state to assert its taxing authority over an out-of-state taxpayer, such taxpayer must have a "substantial nexus" with the taxing state. This is where the clarity ends and the uncertainty begins, since the question of when and whether a taxpayer's "nexus" or connection with the taxing state is "substantial" is almost always a question that turns on the facts and circumstances of each individual case.

In the case of sales and use taxes, we know that the "substantial nexus" requirement is met when the taxpayer has a "physical presence" in the taxing state. See *Quill, supra*. However, there are disputes between taxpayers and tax administrators over whether a taxpayer's physical presence is *de minimis* and not sufficient to trigger a tax compliance obligation, or substantial enough to require the collection of sales and use taxes from customers. See e.g., *Amazon.com LLC v. New York State Dept. of Taxation and Finance*, ___ N.Y.S. 2d ___, 2009 WL 69336 (N.Y. Sup. 2009).

Whether the physical presence "nexus" standard applied by the Court in *Quill* to sales and use tax collection obligations extends to other types of taxes, such as income or other business activity taxes, is the subject of much litigation. See, e.g., *Geoffrey v. South Carolina Tax Commission,* 313 S.C. 15 (1993) (physical presence test of *Quill* does not apply to state income taxes); *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999) (physical presence required for imposition of corporate net income taxes).

Thus, depending on the state, physical presence may or may not be the nexus standard for determining when an out of state taxpayer has an obligation to pay a state's business activity tax. Since the Court's 1992 decision in *Quill,* the Court has not clarified the "nexus" requirement for imposition of state taxes on interstate commerce; the Court declined to take any of the several petitions for certiorari that raised the issue.

Additionally, attempts by some states to impose a business activity tax on a non-resident business that has no physical presence is out-of-step with international tax treaty norms which even permit foreign firms a limited amount of physical presence before they will subject it to local taxes. See Model Tax Convention on Income and Capital, Organization for Economic Co-Operation and Development. Thus, a foreign firm with no physical presence in a state could be subject to state taxes but, because the federal government has a tax treaty with the firm's host country having a different jurisdictional standard, the firm would not be subject to federal income taxes. There is no sound policy basis for this disconnect and no reason why the states should be allowed to be so out-of-step with international tax norms.

Congress Has a Role;

There is no question that Congress has a role to play in bringing clarity to the definition of "nexus." First, the Supreme Court has noted that Congress is best suited to resolve these issues:

> This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, [n.10] but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions.
>
> *Id* at 318.

The Supreme Court thus has made it clear that Congress, pursuant to its power under the Commerce Clause, is the ultimate arbiter when it comes to defining the contours of the interstate taxing powers of the states. Indeed, the above quote from the *Quill* decision seems almost an invitation for Congress to exercise such power. The fact that the Court has not spoken on the issue of "nexus" in the 18 years since it issued the *Quill* decision suggests that the Court is disinclined to offer much needed guidance with respect to these issues.

Additionally, the Congress previously used its power under the Commerce Clause to provide some guidance for interstate taxpayers. In 1959, in response to the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U. S. 450 (1959), Congress enacted P.L. 86-272 prohibiting states from imposing net income taxes on out-of-state taxpayers whose only contacts with a state were the solicitation by employees or representatives of a seller of orders for sales of tangible personal property where the orders were sent out of the state for acceptance and were fulfilled by shipment or delivery from a point outside the state. See 15 U.S.C. Sec. 381.

The problem with P.L. 86-272 is its 1959 vintage. P.L. 86-272 does not encompass the myriad interstate business practices which have grown up since the enactment. Because it is limited to sales of tangible personal property, P.L. 86-272 may not apply to licenses of software nor sales of electronically delivered services, business models that did not exist in 1959. Nor does P.L. 86-272 encompass other types of state taxes, such as gross receipts taxes, which were not in favor at the time of its enactment and which states have since imposed in order to circumvent P.L. 86-272's protections.

States are becoming increasing aggressive in pursuing out-of-state companies with no physical presence in the taxing state for state income or other business activity taxes. These companies with no physical presence consume no state resources for which they ought to compensate. These states seek to export their tax burden to taxpayers who play no role in the political life of the state.

Congress Should Act:

As noted above, there is confusion and uncertainty over the application of the "substantial nexus" standard and Congress has the power under the Commerce Clause to address clarify when out-of-state taxpayers have a tax obligation to another state. There is legislation pending, The Business Activity Tax Simplification Act of 2009, H.R. 1083 ("BATSA"). This legislation would make it clear that an out-of-state firm has no obligation to a state for a tax based on business activity unless the firm has a physical presence in the state. The bill would clarify what physical presence means and quantify the level of physical presence a firm must have in a state

before a tax obligation arises (Congress also should adopt a similar bright-line standard for sales and use tax collection obligations). The bill would modernize P.L. 86-272 so that it applies to software licenses, sales of services and other types of business activity taxes.

BATSA has the support of a majority of the House Judiciary Committee and we urge the subcommittee to mark the bill up and report it to the full committee at its earliest opportunity.

Conclusion:

SoFTEC thanks the Chairman and ranking member of the Subcommittee for holding this important hearing and for the opportunity to submit these remarks and ask that they be made a part of the record of the hearing.

MOTION PICTURE ASSOCIATION
OF AMERICA, INC.
1600 EYE STREET, NORTHWEST
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February 4, 2010

The Honorable Stephen Cohen, Chairman
The Honorable Trent Franks, 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 State Taxation: The Role of Congress in Defining Nexus

Dear Chairman Cohen and Ranking Member Franks:

On behalf of the Motion Picture Association of America, Inc. (MPAA)[1], I thank you for the opportunity to submit this statement for the record for the February 4, 2010, hearing on State Taxation: The Role of Congress in Defining Nexus.

I. Introduction

The MPAA has a particular interest in business activity tax nexus and specifically in H.R. 1083 (the Business Activity Tax Simplification Act). The MPAA strongly supports H.R. 1083 and respectfully urges your Subcommittee and the Judiciary Committee to markup and report out this legislation for consideration by the full Congress. The MPAA believes that a bright-line physical presence standard as provided in H.R. 1083 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.

[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.

This issue is of particular concern to the MPAA because of the aggressive actions taken by states in recent years against film companies and related entities, such as broadcasters. For example, states 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. 1083 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. 1083, 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 taxes 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. 1083 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 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. 1083 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 imposition of a business activity tax. Businesses only receive these meaningful benefits and

[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).

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. 1083 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 to promote the sale of a film on DVD (i.e., tangible personal property), the orders for which are accepted and shipped or delivered from outside the state, these in-state solicitation activities 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 the digital download (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. 1083, to protect the solicitation of orders for services and intangible property. As our economy continues to shift towards intangibles and services, it is important that these sectors of the economy be afforded the important protections of Public Law 86-272.

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. 1083 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. 1083 for consideration by the full Congress.

Sincerely,

A. Robert Pisano
President and Interim Chief Executive Officer
Motion Picture Association of America

Statement of David Rolston, President and CEO of Hatco Corporation, on behalf of the North American Association of Food Manufacturers

Submitted to the Commercial and Administrative Law Subcommittee of the House Judiciary Committee, February 4, 2010

Re: H.R. 1083, the Business Activity Tax Simplification Act

The North American Association of Food Equipment Manufacturers, representing more than 600 US companies that manufacture commercial food preparation, cooking, storage and table service equipment used in restaurants, cafeterias, and other food service establishments, strongly urges the Subcommittee to report out H.R. 1083, The Business Activity Tax Simplification Act.

The current practices of some states to assert "business activity taxes" on sales of firms that have no physical presence or other "nexus" in their states is disruptive to commerce across state lines. These practices are inconsistent among states and discriminatory in application. They interfere with intelligent business planning and therefore to the economic growth and economic health of firms that do business across state lines. H.R. 1083, introduced with strong bipartisan support, would correct this situation before further harm is done.

Allow me to elaborate from the experience of my own firm. I am David Rolston, President and CEO of Hatco Corporation., a manufacturer of commercial food warming equipment, toasters, and water heaters headquartered in Milwaukee, Wisconsin. We have 375 employees, and the company is 100 percent employee-owned.

I also am chair of the Government Relations Committee of the North American Association of Food Equipment Manufacturers,

This is a surprisingly large industry. Total domestic sales are over $8 billion -- and it is an industry composed predominantly of small businesses. Sixty-six percent of the members have sales less than $10 million a year with fewer than 100 employees. We have members from 46 states of the union. Typical products are freezers, refrigerators, stoves, ovens and broilers, food warmers, display tables, serving trays, cutlery-- virtually everything you would see in a commercial restaurant kitchen or food service area. Most, like Hatco, are single-state companies, and have no physical presence outside their home states.

Efficiency and predictability are essential to a small business. The practice of some states to assess "business activity" taxes on firms that have no physical presence in the taxing jurisdiction is a significant administrative cost, adding an unnecessary layer of inefficiency, and limiting our ability to grow.

Hatco, like most NAFEM members, sells through independent manufacturers' representatives who represent 10-15 companies. We also use independent service agents to complete warranty repairs on our equipment. Again, these are independent companies that service the equipment of many different manufacturers. We have no employees or other physical presence outside of Wisconsin. Nonetheless, we are now being forced to pay business activity taxes in four states where we have customers but no physical presence. Justification given by the states for these taxes is the existence of the representatives or service agents.

Of course, our manufacturers' representatives and service agents in these states do pay income taxes on their own business profits in their own states, just as we pay income taxes in Wisconsin. That is as it should be. We should be paying taxes in states where we have presence and receive government services. For us, that is Wisconsin. We should not be paying business activity taxes – which are a form of income tax – where we have no physical presence. (These are not, of course, sales taxes – a clarification I am sure is not needed in this committee; these business activity taxes are quite different from and on top of sales taxes.)

We don't know what other states will come at us next. These tax bills catch us by surprise. When states first contact us, they sometimes come on hard. One state originally demanded that we pay eight years of back taxes. This would have been significant. Others have threatened penalties. Litigation, of course, is impractical for a small firm. We try to negotiate, 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.

One example: very recently, we were subjected to an audit by the State of Washington Department of Revenue, one of the 4 states in which we already pay a Business Activity Tax. They audited the excise tax returns filed by Hatco for the period 1/1/06 to 6/30/09 related to business and occupation (B&O) tax.

The B&O tax in the state of Washington is a business "privilege" tax assessed on the value of shipments made by Hatco into the State of Washington. Hatco has no physical presence in the state of Washington but is still required to periodically report and pay the B&O tax..

The state of Washington originally notified Hatco in 2005 that we owed the B&O tax. This resulted in Washington's initial audit of Hatco and a very lengthy and costly audit and appeal process in 2005 and 2006. That audit covered the period 1/1/98 - 9/30/05. Hatco begrudgingly settled the audit on 7/26/06 after much cost and time was spent contesting the B&O taxation.

The auditor in charge of the recent audit initially was not even aware of the prior audit; yet after Hatco informed her of the prior audit and she located the files in the State of Washington's archives, she nonetheless contended that she needed to perform an audit for the period 1/1/06 - 6/30/09.

Please be aware that our quarterly B&O taxes are approximately $1,000...there is simply not much at stake here.

Nonetheless we had to go thru the audit. The audit included an introductory on-site meeting on 8/25/09, numerous email and telephone exchanges, preparation of data files and copies of various documents as requested by the Washington auditor, and consultation with our CPA tax advisors.

Ultimately Hatco received a letter dated 12/1/2009 from the State of Washington Department of Revenue indicating "no tax adjustments were made since no errors were found...".

Hatco's accounting and information services personnel incurred approximately 40 hours of time in order to comply with the various requests from the Washington state auditor. Hatco also incurred some outside professional fees from its CPA tax advisors.

What are the consequences? Think about where this is going. Facing business activity taxes assessed by four states where we have no presence is bad enough, but 20 states? 30 states? We would have to add staff just to attempt to keep track of these unforeseeable obligations, file the returns, and stay clear of penalties and demands for back taxes. These would, of course, be unproductive employees – a hit to our efficiency. And bear in mind that we are a 100 percent employee-owned company. Any added costs hurt every employee.

And what about the overall impact on the economy? The taxes we pay to states where we have no physical presence come off our net profits. So do the administrative costs. As our net income after expenses is reduced, the taxes we owe to Wisconsin and to the federal government also are reduced. After you factor in both the added taxes and the added administrative costs, both to us and to the states, I doubt that anyone is coming out ahead.

Certainly if other states jump on this bandwagon, we will just be spreading the taxes around, with little, if any, net benefit to anyone.

As a small manufacturer in the US, we face many threats from competitors outside our borders. We continue to be successful by staying lean and smart. Adding unnecessary headcount to administer programs like activity taxes makes us less competitive with overseas companies.

For many years, it has been the presumption that businesses pay taxes only in states where they have physical presence and receive government services. We believe the Congress should act to preserve this standard. H.R. 1083 would serve this purpose.

The Honorable Steve Cohen, Chairman
The Honorable Trent Franks, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515

February 4, 2010

Re: State Taxation: The Role of Congress in Defining Nexus

Dear Chairman Cohen and Ranking Member Franks:

Mr. Chairman and Members of the Committee, I am Rebecca Paulsen, Vice President, State Tax, for U.S. Bancorp. I appreciate the opportunity to share with you my views on the important issue that you have before you—the role of Congress in defining nexus for Business Taxpayers.

U.S. Bancorp (NYSE: USB), with $281 billion in assets as of Dec. 31, 2009, is the parent company of U.S. Bank, the fifth largest commercial bank in the United States. The company operates 3,015 banking offices in 25 states as well as 5,148 ATMs, and provides a comprehensive line of banking, brokerage, insurance, investment, mortgage, trust and payment services products to consumers, businesses and institutions.

Businesses Need Clarity and Certainty to Proceed;
Unclear Nexus Rules Preclude Their Ability to Make Good Business Decisions

This testimony in support of H.R. 1083, the Business Activity Tax Simplification Act, is submitted to encourage your recommendation of this bill to both ease the burden of tax compliance on American businesses, and to provide some clarity and uniformity in state business taxes. It is a well-established fact that businesses are under significant strain due to the severe downturn in the economy; and it is also a fact that uncertainty of any kind, but particularly that imposed by government, discourages companies from investing, hiring and growing – exactly what this country needs to get back on its collective feet.

I am not normally an advocate of federal preemption of states' rights; however, the unprecedented proliferation of complicated, expensive, and onerous taxation schemes that have been heaped upon business taxpayers by many, many jurisdictions over the last several years have pushed me to request that Congress step in to restore some semblance of order in an otherwise chaotic system of confusing and often conflicting state laws. In their attempt to close ever-widening budget holes, along with a need in some cases, to appease voters' calls for businesses to "pay their fair share," state legislators have caused more problems than they have fixed, and have surely slowed the economic recovery we all hope to see.

H.R. 1083 would provide some much-needed clarity in the otherwise murky world of state income taxation, with respect to what subjects a business to taxation in a particular jurisdiction. It has long been held that in order for a state or other political jurisdiction to tax a profit-making enterprise, that enterprise had to be physically present in the state – utilizing the services and reaping the benefits provided by the governmental bodies in that jurisdiction. However, due in part to shrinking state coffers and growing state budgets, state politicians are increasingly looking to businesses to make up the gap – businesses, as we all know, can't vote.

This would appear to be a logical solution on its face, but when looked at more closely, this is exactly the wrong answer to the problem. Businesses have three main constituents: Employees, Customers, and Shareholders. All three of these groups are adversely affected when there is uncertainty about the future; businesses tend to be reluctant to act in these situations – capital is hoarded, open positions are not filled, new products are not developed, and dividends are not paid. This creates a circular chain of events that, until it is broken, will keep the business (and the broader economy) on a downward spiral – less spending, fewer employees, lower wages, less profit, and fewer dividends – everybody loses. Even the government. Because when businesses hire fewer workers, pay lower wages, restrict investment, become unprofitable, and reduce dividends, the tax revenue from every one of those activities goes down or even away.

Examples of the uncertainty surrounding the area of tax nexus for businesses can be found in just about every jurisdiction, but several high profile cases over the past few years, as well as some very new proposals being floated by state legislatures, provide specific instances where H.R. 1083 would be most helpful, both in reducing compliance costs, and in providing certainty regarding the future tax effects of business decisions made today.

Many companies, including financial services companies, are subject to tax in multiple jurisdictions, each one of which has its own method of taxing business income. Additionally, states and localities have differing means of determining who is subject to tax in their jurisdiction. This dizzying array of varying methodologies imposes a significant compliance burden on taxpayers, draining precious resources away from the productive enterprise into the nonproductive exercise of filling out governmental paperwork.

The means of determining taxation have changed over the past several years, from being primarily driven by the physical location of the company, rather than the location of the customers. This was ostensibly due to the need for governments to recover the cost of services provided to businesses operating within their borders. Of late, however, some taxing jurisdictions have begun requiring business taxpayers to file and pay taxes based not on where the *company* is located, but based on where the *customers* of the company are located.

Some states are beginning to assess penalties; in the case of Washington state, a new, 35% penalty has been proposed, which would be assessed against any business taxpayer which, in the Department's opinion, had engaged in an "abusive" transaction. Based on anecdotal evidence, and with the change to economic nexus, taxpayers are legitimately concerned that they could be subject to a gross receipts tax, based purely on sales to Washington residents, which would in some cases exceed the profit margins on the products and services being sold, plus a 35% penalty, because they did not file a Business and Occupation tax return for a subsidiary which has no presence in the state.

The state asserts that the business is benefitting from all the services provided by the state's government, and therefore, it must be required to pay taxes to reimburse the state for spending all that money to provide those services. However, the services typically cited by the government are for things like police and fire protection (whose, if the business is not actually there?) a court system (how many out-of-state companies actually use the court system of a state in which they are not present, and don't they generally have to pay court costs separately, anyway?), roads and public transportation (again, whose, if the business is not even present?) and for "a marketplace," (how does that cost the government anything?). The total state and local business tax burden is 83% higher than the estimated value of public services directly benefiting businesses.[1] The "reimbursement" argument for businesses with no physical presence in a taxing jurisdiction is fallacious, and must be removed from the debate.

Public Law 86-272 Protection Should be Available to Everyone

Taxpayers were afforded some protection from the whims of state revenue collectors through the actions of Congress in the passage of P.L 86-272, which offers a bright line test for nexus-causing activities of businesses making sales of tangible personal property. This test, however, does not provide any certainty for businesses which either do not sell tangible personal property, or may be subject to a non-net income based tax. P.L. 86-272 only applies to net income taxes. So any gross receipts, capital, or modified gross receipts tax levied on businesses would not fall under the purview of P.L. 86-272 protection.

This has caused many businesses a great deal of difficulty in determining if they are required to file returns and pay taxes in jurisdictions where prior to the new form of taxation, they had no filing requirement. This causes problems in the financial accounting world because under the standard accounting rules, companies are required to record a reserve for potential taxes that are "more likely than not" going to be due. A business has no way to determine, absent an audit (and unless the taxpayer chooses to litigate, in this world of massive budget deficits, the Revenue Departments will choose to err on the side of assessing the tax and hoping that it sticks), if it is required to file and pay the tax. These compliance costs, coupled with the financial statement impact of reserving for possible additional taxes, are adding a burden to the nation's businesses that is not only unhelpful to the recovery process, but in fact harmful.

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[1] Total State and Local Business Taxes, 50 state estimates for the fiscal year. Ernst & Young – Andrew Phillips, Robert Cline, and Thomas Neubig.

Additionally, the pro-tax advocates argue that businesses must pay their "fair share" of taxes. How that is defined, and who gets to decide what is "fair" has morphed over the years to being "as much as we can get away with" and "anyone with a good cause," respectively. Businesses already pay over 44% of all state and local taxes in this country.[2] As unemployment goes up, and corporate net income taxes are changed to gross income taxes, (so that drops in corporate income do not result in drops in corporate tax), the ratio of business-to-consumer taxes is only going to increase.

Conclusion

The real issue is that businesses do not pay taxes – people do. And if a government levies a tax on a business, that business will pass the tax on to one of the three constituents above – its employees, its customers, or its shareholders – or any combination of the above. This equates to being a sneaky way to raise taxes on individuals without telling them that it is happening. Businesses should only pay enough tax to reimburse the taxing jurisdiction for the goods and services it provides to the business – an educated workforce, roads and bridges (infrastructure), police and fire protection, access to the court system, and in the case of the federal government, national security. Business taxes which purport to tax a business fairly would not include levying a tax on the income of a company with no physical presence in the state, since that business would be deriving no benefits from the state which would cost money to provide.

A fairer solution to the question of state and local business taxation is contained in the language of H.R. 1083, and I respectfully urge your support.

[2] Id.

The Computing Technology Industry Association

Testimony Before the

Subcommittee on Commercial and Administrative Law

House Judiciary Committee

"State Taxation:
The Role of Congress in Defining Nexus"

February 4, 2010

Introduction.

Good afternoon, Chairman Cohen, Ranking Member Franks, and distinguished members of the Subcommittee. This testimony is submitted on behalf of the Computing Technology Industry Association (CompTIA) representing small computer services businesses called Value Added Resellers, also known as "VARs".

I want to thank Chairman Cohen and Members of this Subcommittee for holding this important hearing concerning the role of government in defining *nexus*, for purposes of state taxation issues. This is a real issue affecting the economic survival of small businesses, so it is very important that Congress act to bring certainty and consistency in the determination of *nexus*. 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.

About CompTIA.

The Computing Technology Industry Association (CompTIA) is the voice of the world's $3 trillion information technology industry. CompTIA membership extends to more than 100 countries. Membership includes companies at the forefront of innovation along with the channel partners and solution providers they rely on to bring their products to market and the professionals responsible for maximizing the benefits that organizations receive from their technology investments. The promotion of policies that enhance growth and competition within the computing world is central to CompTIA's core functions. Further, CompTIA's mission is to facilitate the development of vendor-neutral standards in e-commerce, customer service, workforce development, and ICT (Information and Communications Technology) workforce certification.

CompTIA's members include thousands of small computer services businesses called Value Added Resellers (VARs), as well as nearly every major computer hardware manufacturer, software publisher and services provider. Our membership also includes thousands of individuals who are members of our "IT Pro" and our "TechVoice" groups. Further, we are proud to represent a wide array of entities including those that are highly innovative and entrepreneurial, develop software, and hold patents. Likewise, we are proud to represent the American IT worker who relies on this technology to enhance the lives and productivity of our nation. Based upon a recent CompTIA survey, we

estimate that one in twelve (or about 12 million American adults) considers him or herself to be an IT worker. This is larger than the number of American adults classified by the Bureau of Labor Statistics (BLS) as employed in farming, mining, and construction combined. This is also close to the number of adults classified by BLS as working in manufacturing or transportation. CompTIA has concluded that the IT workforce is now one of the largest and most important parts of the American political community.

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.

CompTIA
February 4, 2010

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 transaction 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 multiple 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.*

CompTIA
February 4, 2010

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.

This issue will be further compounded as *cloud computing* grows in usage. Consider the example of the delivery of business applications online to a user in State X, which business applications are stored on a server owned by the vendor in State Y, while the data generated from use of the business applications is stored on another server located in State Z.

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 tax 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 tax 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 authority 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 – i.e., physical "nexus" – to allow that state to impose business activity taxes.

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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 a substantial burden and cost on all businesses with a disproportionate impact on small businesses, especially those engaging in electronic commerce.

Legislation.

Accordingly, we call on Congress to pass H.R. 1083, the "Business Activity Tax Simplification Act of 2009" which would establish consistent rules concerning *nexus* to (i) expand the federal prohibition against state taxation of interstate commerce to include taxation of out-of-state transactions involving all forms of

property (such as intangible personal property and services) and (ii) prohibit state taxation of an out-of-state entity unless such entity has a physical presence in the taxing state.

Conclusion.

Increasingly, businesses are being burdened by 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 small technology company members, which rely more heavily on income from the remote provision of interstate services.

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Mr. FRANKS. As many of those groups know, I am a co-sponsor of several State tax-related measures along with some of the individuals on the other side of this aisle, and I encourage the Chair-

man of the Subcommittee to move on a markup of those bills as soon as is practicable.

That said, you know, I am sort of a reluctant co-sponsor of State-tax-related measures simply for the reason that I am a strong believer in the 10th Amendment, which says, "The powers not delegated to the United States by the Constitution nor prohibited by it to the States are reserved to the States respectively or to the people." That is not really that hard to understand, but it is hard to apply here.

We will hear from our distinguished panel today about how the Commerce Clause prohibits a State from taxing an entity that lacks a substantial nexus with that State. For sales taxes on the sale of physical goods, that restriction has been limited to companies that have a physical presence in the State.

The Commerce Clause also prohibits a State from imposing a tax regime that disproportionately affects out-of-state vendors in favor of in-state companies.

And I hope we will also learn how the due process clause of the 14th Amendment requires that a State have certain "minimum contacts" with a company before that State can tax that company.

And we also hope to hear how Congress has the authority to shape tax authority by States under the Commerce Clause.

What I would like to hear from today's witnesses, however, is really more a subtle question, perhaps even more important. And that is when should Congress use its Commerce Clause powers to regulate States' taxing authority, and how should the 10th Amendment constrain Congress' authority on these matters.

If it sounds like I am siding with the States on these questions, Mr. Chairman, to a significant degree I am. I believe the founders created a Federal Government with limited powers.

However, as I said before, I also believe that some of the—these tax bills are necessary to ensure the flow of interstate commerce, and that is definitely one of the powers that was given to Congress as well under the Constitution.

So for my friends in State government, I have a question. When is a good time for Congress to regulate in this area?

Time and time again, the States and localities have come to Congress saying that they cannot afford for Congress to cut their revenue, and I understand that. I mean, but they have said when the coffers are full and when the coffers are empty. So that has been consistent.

But given we know that we cannot tax our way to prosperity, I want to know when is a good time for Congress to assist States in making some much-needed tax reforms.

So that is the mission from my perspective, Mr. Chairman, and I look forward to hearing from our witnesses on these and other questions, and I yield back the balance of my time.

Mr. COHEN. Thank you, sir.

As I understand it, no one on the Republican side is desiring to make an opening statement. There are a few folks on the Democratic side that would like to make a brief opening statement, and there is one person on the Democratic side that would like us to have no opening statements because he is so interested in hearing the panel.

Because we have come here late, no—through mostly no fault of theirs, a little bit of mine, but mostly the Congress' for the votes, I am going to ask anybody that wants to make a statement to make a statement but to limit your remarks to 2 minutes.

So with that, Ms. Lofgren, you are recognized, and you are in the 2-minute zone.

Ms. LOFGREN. Thank you, Mr. Chairman. I will take 2 minutes.

This is an important hearing, and I think there are certainly academic issues that will be addressed. But I hope that the witnesses will talk about not just the impact on State and local governments, which we care about—I was a county supervisor for 14 years before I came here—but also the impact that State and locals can have on our business environment.

I think that we need to be concerned that local governments—and I did the same when I was there—have to meet a bottom line. Their job is not to worry about the national economy. Their job is to meet their payroll.

But the Congress has a responsibility for the entire economy of the country, and unduly burdening electronic commerce with the patchwork of taxes may have an impact on economic growth.

So I just wanted to put that out there in the hopes that the witnesses will address it, and I am eager to hear them.

And I will yield back, Mr. Chairman.

Mr. COHEN. Thank you, Ms. Lofgren.

Chairman Johnson is recognized for 2 minutes.

Mr. JOHNSON OF GEORGIA. Thank you, Mr. Chairman. Thanks for holding this important hearing on State taxation today.

Today we will examine the intricacies of nexus and its impact on State taxation. We will also have the opportunity to examine the pending legislative proposals before this Subcommittee regarding State taxation.

This hearing is necessary because States have widely varying and inconsistent requirements regarding taxation. The Supreme Court has acknowledged that Congress has the authority under the Commerce Clause to legislate in the area of nexus for State tax purposes.

Therefore, Congress should take action to simplify the tax system and make it fair for individuals, States and businesses. This is why I introduced H.R. 2110, the "Mobile Workforce State Income Tax Fairness and Simplification Act."

This legislation provides for a uniform, fair and easily administered law that would ensure that the correct amount of tax is withheld and paid to States without the undue burden that the current system places on employees as well as employers.

Understanding nexus is extremely important because it directly affects our districts and their ability to collect revenue for essential services that benefit our constituents.

I thank the Chairman for holding this hearing, and I look forward to hearing from our witnesses today. Thank you.

Mr. COHEN. Thank you, sir.

Mr. Scott, Chairman Scott, are you—is that who is next? He is gone? Ms. Chu is left.

Welcome. I am now pleased to introduce the witnesses and hear the testimony for today's hearings. First, thank you all for partici-

pating in today's hearing. Without objection, your written statements will be placed into the record and we would ask you limit your oral remarks to 5 minutes.

You will note that we have a lighting system. It starts with a green light. At 4 minutes, it turns—it doesn't turn yellow; at 4 minutes a yellow light comes on. The green light goes off. And then the red light comes on at 5 minutes, and that means you should have concluded by that time.

After each witness has presented his or her testimony, Subcommittee Members will be permitted to ask questions subject to the same 5-minute limit.

First witness is Mr. Walter Hellerstein. Professor Hellerstein is the Francis Shackelford Professor of Taxation at the University of Georgia Law School. He is co-author of State Taxation Volumes I and II and other tax manuals—over 100 journal articles he has published.

Professor Hellerstein has practiced extensively in the State tax field and has been involved in numerous State tax cases before the U.S. Supreme Court. He did not teach Herschel Walker.

Thank you for being here, Professor Hellerstein. Begin your testimony.

TESTIMONY OF WALTER HELLERSTEIN, FRANCIS SHACKELFORD DISTINGUISHED PROFESSOR IN TAXATION LAW, UNIVERSITY OF GEORGIA SCHOOL OF LAW

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

My testimony addresses three basic questions. First, what is State tax nexus? Second, what can Congress do about State tax nexus? And third, what should Congress do about State tax nexus?

First, what is State tax nexus? Essentially, State tax nexus is the minimum required constitutional connection that a State needs to tax a taxpayer or to require someone to collect a tax.

For the most part, that nexus had been defined by the courts because Congress has only rarely enacted statutes relating to nexus.

And the general rule under the due process clause for all taxes is that nexus is created even without physical presence if a taxpayer purposely directs its activity toward a State as, for example, by selling to in-state customers.

The way the law now stands with regard to the Commerce Clause is that nexus for purposes of collecting a sales or use tax requires the physical presence of the seller.

With regard to the imposition of income taxes, however, no physical presence has been required. Instead, courts have looked to what they call economic or—presence or a significant exploitation of the State's market. So that is where the law stands.

What can Congress do about State tax nexus? The answer is Congress can pretty much do anything it wants in this area, subject only to the very loose restraint that it cannot authorize a violation of the due process clause.

In fact, the courts, in talking about this very issue, said, "No matter how we evaluate the burdens, no matter what the court says, Congress remains free to disagree with our conclusions." Ac-

cordingly, Congress is free to decide whether, when, and to what extent States may burden interstate mail order concerns with a duty to collect use taxes.

Third, what should Congress do about State taxes? I should make it clear that I have not been asked to address the specifics of the proposed legislation.

Instead, I am just going to share with the Subcommittee some of my general—some important considerations that I think the Subcommittee should take into account in considering what, if anything, to do about the various nexus proposals.

First, in my view, there is no one-size-fits-all solution to the State tax nexus problem. A solution to one problem—for example, a 30-day physical presence rule for triggering a tax withholding obligation—may well be inappropriate for another problem—for example, whether or not a State vendor should be required to collect a use tax on sales to in-state consumers.

My second point, related to my first, is that nexus issues raised by sales taxes are different from nexus issues raised by income taxes. And Congress should pay attention to that difference. I think I can best illustrate this by an example.

As I think most people sitting in this room know, all States that impose sales taxes on things that are purchased locally also impose so-called use taxes on stuff that people buy outside the State and bring into the State.

The reason for this is that States, quite sensibly, want to impose a uniform tax on all things that are consumed in the State without giving in-State folks an incentive to leave the State to shop elsewhere.

So for example, if a resident of Washington goes to buy a car in Oregon, she doesn't pay a sales tax. Why not? Because Oregon doesn't have a sales tax. She brings the car back to Washington. What happens? She pays a use tax.

The same thing in principle is true when I buy a book from Amazon.com. I don't pay a sales tax because title passes where the—Amazon is. When I receive that book in Athens, Georgia, I owe a use tax.

There is, however, one significant difference. When my Washington resident goes back to Washington, when does she pay the use tax? She goes to register the car and she pays a use tax. Well, pretty simple.

When I buy the book in Athens, Georgia, I just go to the book registry and I register the book, right? Obviously not. As long as we have a First Amendment, we are not going to have book registries.

So the real question in the use tax area—it is clear I owe the tax. The only question is under what circumstances can we reasonably ask someone to help the State collect a tax that is clearly due.

In the income tax area, it is a little bit different. Why? Because in the income tax area, the question as to whether or not a tax is due is not always clear when, for example, there is no presence of a taxpayer in a State.

So there, it is a much more complicated question. I think in looking at these issues, Congress needs to keep in mind these differences.

Third point—and I see my time is about to run out—I think it is very important for Congress to look at the question of physical presence and to ask whether physical presence makes sense or nonsense in the context of a tax collection obligation.

I think we can all agree that requiring a remote seller to comply with a use tax obligation may well impose a burden on interstate commerce if the compliance burdens are unreasonable.

The question, however, is whether physical presence is a good proxy for determining whether such burdens exist.

Is a small business that happens to send a few salespeople into a State, thus establishing a physical presence and triggering a tax obligation, better able to comply with another State's tax laws than a multi-million-dollar out-of-state retailer that may not have physical presence in the State but has sophisticated software programs that not only track a customer's buying habits, frequently informing them of product offers, but also fulfills tax collection obligations of similar businesses that have physical presences in the State?

If not, perhaps there is a better metric than physical presence for determining nexus for use tax collection purposes in the 21st century.

Thank you, and I apologize for going over.

[The prepared statement of Mr. Hellerstein follows:]

PREPARED STATEMENT OF WALTER HALLERSTEIN

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

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

Hearing on
State Taxation:
The Role of Congress in Defining Nexus

A Primer on State Tax Nexus: Law, Power, and Policy

February 4, 2010

I am Walter Hellerstein, the Francis Shackelford Professor of Taxation at the University of Georgia School of Law. I have devoted most of my professional life to the study and practice of state taxation and, in particular, to state taxation of interstate commerce and the federal constitutional restraints on such taxation.

I am honored by the Chairman's invitation to testify today. I welcome the opportunity to share with the Subcommittee my views on the role of Congress in defining nexus. I do not appear here on behalf of any client, public or private, and the views I am expressing here today reflect my independent professional judgment.

My testimony addresses three basic questions. First, what is state tax nexus? Second, what can Congress do about state tax nexus? Third, what should Congress do about state tax nexus?

I. WHAT IS STATE TAX NEXUS?

A. Nexus Defined

Nexus literally means connection. In the state tax context, nexus generally means the connection that a state must have with a person, property, transaction, or activity in order for a state to exercise its taxing power constitutionally over such person, property, transaction, or activity. Thus the U.S. Supreme Court has said that the Due Process Clause requires "some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax"[1] and that the Commerce Clause requires that a tax be applied only to activities "with a substantial nexus with the taxing State."[2]

The Court has frequently repeated this bedrock principle in a variety of contexts. It has declared that "[t]he Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities – even on a proportional basis – unless there is a '"minimal connection" or "nexus" between the interstate activities and the taxing State....'"[3] It has observed that sometimes the nexus question is "whether the State has the authority to tax ... at all,"[4] and sometimes the nexus question is whether a state that has nexus "with the actor the State seeks to tax" also has the requisite "connection to the activity" that is the subject of the tax.[5] And, in cases in which a state clearly has nexus with the taxpayer and the taxable transaction, such as a

[1] *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1954).

[2] *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[3] *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983).

[4] *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 778 (1992).

[5] *Id.*

use tax imposed on a state resident,[6] the Court has focused on the "substantial nexus" that the state must have with an out-of-state vendor to require it to collect the tax.[7]

B. Nexus Delineated

Establishing that nexus means "minimum required constitutional connection" and that the requirement exists in a variety of contexts does not tell us much about what nexus means as a practical matter in these contexts, and particularly, in the contexts in which legislation has been introduced in recent years seeking to limit or expand this connection.[8] Apart from those few areas in which Congress has in fact addressed nexus issues,[9] the delineation of the standards that in fact limit the states' power to tax has fallen entirely to courts through their interpretation of the Due Process and Commerce Clauses. Although one could write an entire treatise on these issues,[10] I briefly summarize these judicially defined nexus standards below.

1. Due Process Clause Nexus versus Commerce Clause Nexus

Prior to 1992, the U.S. Supreme Court had considered the nexus requirement as an element of both its Due Process and Commerce Clause doctrines, and it had never indicated that there was any distinction in the nexus standard under either clause. Indeed, it had suggested precisely the opposite, noting that the Commerce Clause nexus requirement "encompasses as well the due process requirement that there be 'a "minimal

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[6] *General Trading Co. v. State Tax Comm'n*, 322 U.S. 335 (1944)

[7] *See, e.g.*, *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[8] *See, e.g.*, H.R. 1083, "Business Activity Tax Simplification Act of 2009," 111th Cong., 1st Sess. (Feb. 13, 2009); H.R. 2110, "Mobile Workforce State Income Tax Fairness and Simplification Act," 111th Cong., 1st Sess. (April 27, 2009); H.R. 2600, "Telecommuters Tax Fairness Act of 2009," 111th Cong., 1st Sess. (May 21, 2009); H.R. 3396," Sales Tax Fairness and Simplification Act," 110th Cong. 1st Sess. (Aug. 3, 2007). I cannot resist observing that the bills generally share the common themes of "fairness" and "simplification" at least in the eyes of their sponsors, but, for some reason, "fairness" did not make the cut into the title of the Business Activity Tax legislation and "simplification" did not make the cut into the title of the Telecommuters Tax legislation.

[9] *See* Public Law 86-272, 15 U.S.C. §§ 381-84 (prohibiting states from imposing a tax on net income derived by a person from interstate commerce if the person's activities in the state do not exceed "solicitation"); Internet Tax Freedom Act, Public Law No. 105-277, Title XI, § 1104(3), 112 Stat. 2681 (1998) (as amended) (prohibiting states from requiring a remote seller to collect a sales or use tax on Internet sales if the "seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation"); Mobile Telecommunications Sourcing Act, 4 U.S.C. § 116 (authorizing, under specified circumstances, state taxation of charges for mobile telecommunications services, when taxation of such charges might otherwise exceed nexus restraints defined by U.S. Supreme Court; see *Goldberg v. Sweet*, 488 U.S. 252 (1989)).

[10] *See* Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, vols. I & II (3d ed. 1998-2009) (updated tri-annually).

connection" between the interstate activities and the taxing State.'"[11] In *Quill Corp. v. North Dakota*,[12] however, the Court drew a distinction between nexus for Due Process Clause purposes and nexus for Commerce Clause purposes.

Quill raised a single question to which the Court's Commerce and Due Process Clause jurisprudence appeared to provide a single answer: whether an out-of-state mail-order vendor could be required to collect a state's use tax on sales to customers in the state when the seller had no physical presence in the state. As noted above, the Court had never differentiated its Commerce Clause and Due Process Clause analysis of this question. In *Quill*, however, the Court observed that the Commerce Clause's "substantial-nexus requirement is not, like due process' minimum contacts requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce."[13] Consequently, "a corporation may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with the State as required by the Commerce Clause."[14] Indeed, this was precisely the situation in *Quill*.

2. Due Process Clause Nexus

Because "[d]ue process centrally concerns the fundamental fairness of governmental activity,"[15] "the due process nexus analysis requires that we ask whether an individual's connections with a State are substantial enough to legitimate the State's exercise of power over him."[16] The Court had held in the analogous area of judicial jurisdiction that "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State."[17] Applying these standards to the imposition of a tax collection requirement upon an out-of-state vendor, the Court declared that, as long as an out-of-state mail-order vendor purposefully directs its solicitation toward residents of the taxing state, "it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: the requirements of due process are met *irrespective of a corporation's lack of physical presence in the taxing State*."[18] With these principles established, decision on the due

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[11] *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 373 (1991); *see also National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756-57 (1967).

[12] 504 U.S. 298 (1992).

[13] *Id* at 313.

[14] *Id.*

[15] *Id.* at 312.

[16] *Id.*

[17] *Id.* at 307.

[18] *Id.* at 308 (emphasis supplied).

process nexus issue in *Quill* followed easily, since Quill had "purposefully directed its activities at North Dakota residents,"[19] "the magnitude of those contacts are more than sufficient for due process purposes,"[20] and the use tax was "related to the benefits Quill receives from access to the State."[21]

3. Commerce Clause Nexus

The principal concern of the Commerce Clause is national economic unity and "the effects of state regulation on the national economy."[22] In the eyes of the *Quill* Court, the purposes underlying the Commerce Clause gave rise to a nexus inquiry that focused on the burdens the tax collection obligation imposed on interstate commerce rather than on the fairness of imposing the obligation on the out-of-state vendor. The critical question was whether the different nexus inquiries dictated by the different purposes of the Due Process and Commerce Clauses should translate into different substantive nexus standards under the two clauses. The Court answered that question in the affirmative, holding that, at least in the context of use tax collection obligations, the physical-presence test articulated twenty-five years earlier in *National Bellas Hess, Inc. v. Department of Revenue*[23] remained the Commerce Clause "substantial nexus" standard. The Court defended the "bright-line" rule of *Bellas Hess* on the ground that it "firmly establishes the boundaries of legitimate state authority," "reduces litigation," "encourages settled expectations," and serves the "interest in stability and orderly development of the law that undergirds the doctrine of *stare decisis*."[24]

Despite its reaffirmation of the physical-presence standard of *Bellas Hess*, the Court's defense of the old rule was lukewarm at best. The Court acknowledged that its recent Commerce Clause decisions – like its modern Due Process Clause decisions – signaled a "retreat from the formalistic stringent physical presence test in favor of a more flexible substantive approach."[25] Moreover, the Court conceded that "contemporary Commerce Clause jurisprudence might not dictate" the result reached in *Bellas Hess* "were the issue to arise for the first time today."[26] Furthermore, the Court recognized that, "[l]ike other bright-line tests, the *Bellas Hess* rule appears artificial at the edges"[27]

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[19] *Id.*

[20] *Id.*

[21] *Id.* at 298.

[22] *Id.* at 312.

[23] 386 U.S. 753 (1967).

[24] *Quill*, 504 U.S. at 315-17.

[25] *Id.* at 314.

[26] *Id.* at 311.

by drawing a constitutional line in the sand between commercial activity "purposefully directed" to a state through physical presence and economically equivalent commercial activity "purposefully directed" to a state through other means.

a. Income Tax Nexus: Post-*Quill* Case Law

As noted above, *Quill* left open the question of whether the physical-presence rule of Commerce Clause "substantial nexus" that the Court had reaffirmed in connection with sales and use tax collection obligations of an out-of-state vendor applied to other taxes. Whatever room for doubts there may be over the proper resolution of that question, the state courts have not shared them. They have almost without exception held that *Quill*'s physical-presence test of Commerce Clause "substantial nexus" is limited to sales and use taxes and does not apply to other types of taxes, most notably, state corporate net income taxes.[28] Instead of a physical-presence test of substantial nexus, they have adopted of a standard of "economic nexus" or "significant economic presence."[29] As a recent opinion of the Massachusetts Supreme Judicial Court defined this standard in sustaining an income tax imposed on an out-of-state bank without physical presence in the state:

> While the concept of "substantial nexus" is more elastic than "physical presence," it plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. Simply put, the test is "substantial nexus," not "minimal" nexus. In addition to their consumer lending activities, the … banks were soliciting and conducting significant credit card business in the Commonwealth with hundreds of thousands of Massachusetts residents, generating millions of dollars in income for the … banks. … They could not provide [valuable financial] services in the Commonwealth without using Massachusetts banking and credit

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[27] *Id.* at 315.

[28] *See, e.g.*, *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76, 86-87 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009); *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E.2d 87 (Mass. 2009), *cert. denied*, 129 U.S. 2853 (2009); *Lamtec Corp. v. Department of Revenue*, 215 P.3d 968 (Wash. App. 2009) (business gross receipts tax); *Bridges v. Geoffrey*, 984 So. 2d 115 (La. App. 2008); *Lanco, Inc. v. Director, Div of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004); *Kmart Properties, Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. App. 2001); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). See generally 1 Hellerstein & Hellerstein, *supra* note 10, at ¶ 6.11[3][a] (collecting and discussing cases).

[29] *Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

> facilities.....[W]e conclude that the ...banks' activities in Massachusetts established a substantial nexus with the Commonwealth ....[30]

In short, the law of Commerce Clause "substantial nexus" as it now stands in most states is that a state may not impose a use tax collection obligation upon an out-of-state vendor without physical presence in the state but may impose an income tax upon an out-of-state taxpayer without physical presence in the state with respect to income derived from sources within the state if the taxpayer has significantly exploited the state's market.

II. WHAT CAN CONGRESS DO ABOUT STATE TAX NEXUS?

The short answer to this question is, "just about anything," subject to the relaxed nexus restraints of the Due Process Clause described above. Indeed, there should be no serious debate over Congress's broad authority to adopt or consent to virtually any rule that it believes is appropriate in this domain.

First, it is critical to understand that the judicially developed restraints on state taxing power that the Court has articulated under the Commerce Clause are simply irrelevant in determining the scope of congressional authority to exercise its affirmative "Power . . . [t]o regulate commerce among the several States . . . ."[31] Those judicially developed restraints on state taxing power, which the Court has delineated under the so-called "dormant" or "negative" Commerce Clause, are controlling only when Congress itself has not exercised the constitutional authority that it enjoys under the Commerce Clause. When Congress exercises its own power under the Commerce Clause, it may consent to state legislation affecting interstate commerce that would be unconstitutional under the "dormant" Commerce Clause in the absence of such consent, and it may preempt state legislation that would be constitutional under the dormant Commerce Clause in the absence of such preemption.

As the U.S. Supreme Court has declared, the "plenary scope" of the congressional commerce power

> enables Congress not only to promote but also to prohibit interstate commerce, as it has done frequently and for a great variety of reasons. That power does not run down a one-way street or one of narrowly fixed dimensions. *Congress may keep the way open, confine it broadly or closely, or close it entirely*, subject only to the restrictions placed upon its authority by other constitutional provisions and the requirement that it shall not invade the domains of actions reserved exclusively for the states.[32]

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[30] *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76, 86-87 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009).

[31] U.S. Const. art. I, § 8, cl. 3.

[32] *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 434 (1946) (emphasis supplied).

Second, in light of Congress's broad power to legislate under the Commerce Clause, we can now appreciate the significance of the Court's having rested its holding in *Quill* entirely on the Commerce Clause. Because the Court based the physical-presence requirement for mandatory collection of use taxes exclusively on the Commerce Clause, Congress clearly retains ample power to modify that rule (as well as any other rule the Court has articulated under the Commerce Clause) in forging a legislative solution to the problems of state taxes affecting interstate commerce. Indeed, the Court could not have been more explicit about this point in *Quill*. Thus, in justifying its refusal to renounce the "bright-line" physical-presence test of *Bellas Hess*, the Court declared:

> This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. Indeed, in recent years Congress has considered legislation that would "overrule" the *Bellas Hess* rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in *Bellas Hess* that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, *Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes.*[33]

Finally, let me briefly address the limitations on Congress's power to enact legislating expanding, restricting, or otherwise prescribing rules governing state taxation affecting interstate commerce. It is true that some of the Court's more recent decisions construing Congress's affirmative power under the Commerce Clause have taken a narrower view of that power than the Court articulated during the New Deal era,[34] when it sustained the broad exercise of congressional power to regulate even local activities that may affect interstate commerce.[35] But these decisions do not seriously inhibit the

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[33] *Quill*, 504 U.S. at 318 (footnotes and citations omitted, emphasis supplied). In a similar vein, but in a slightly different context, the Court has declared that "[i]t is clear that the legislative power granted by the Commerce Clause of the Constitution to Congress would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income." *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978).

[34] *See United States v. Morrison*, 529 U.S. 598 (2000) (Congress lacks the power under the Commerce Clause to provide a civil remedy for victims of gender-motivated violence because gender-motivated crimes do not substantially affect interstate commerce); *United States v. Lopez*, 514 U.S. 549 (1995) (Congress lacks the power under the Commerce Clause to prohibit possession of firearms in school zones because possession of a gun in a local school zone does not affect interstate commerce).

[35] *See, e.g.*, *Wickard v. Filburn*, 317 U.S. 111 (1942) (sustaining Congress's power to regulate under the Commerce Clause the amount of wheat a farmer grew for his own consumption).

extensive power that Congress plainly possesses to deal with the problems raised by state taxes affecting interstate commerce and, in particular, state tax nexus rules.[36]

III. WHAT SHOULD CONGRESS DO ABOUT STATE TAX NEXUS?

I come finally to the only controversial question addressed in this testimony. I should make it clear that I have not been asked to weigh in on the details of any of the proposed legislation that is (or has been or is likely to be) before this Subcommittee,[37] and I will not do so today, although I am on record in expressing my approval in principle of one of the bills now before this Subcommittee.[38] I will instead share with the Subcommittee what I believe are some important considerations to keep in mind in determining what, if anything, it should do about the state nexus issues raised by the various proposals. In an act of extraordinary self-restraint, I limit myself to three.

A. There is No "One Size Fits All" Solution to Nexus Issue

In its consideration the various proposals for limiting, expanding, or otherwise modifying the existing nexus rules embodied in judicial doctrine, the Subcommittee should keep in mind that there is no global or "one-size-fits-all-solution" to the problems involved. Each of the problems and each of the proposed solutions arises in a different context and a solution for one problem (e.g., a 30-day physical presence rule for triggering a withholding obligation) may well be inappropriate for another problem (e.g., whether an out-of-state vendor should be required to collect a use tax on sales to in-state consumers). If the Subcommittee is going to recommend nexus legislation consistent with

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[36] *See generally* Walter Hellerstein, "Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce," 53 *National Tax Journal* 1307 (2000).

[37] *See supra* note 8.

[38] Testimony of Walter Hellerstein on the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007 (H.R. 3359) before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary (November 1, 2007). In that testimony, I said that, in my opinion, enactment of the proposed legislation "would constitute an appropriate exercise of congressional power." *Id.* at 9. In expressing that opinion, however, I also made it clear that "the states have a legitimate interest in assuring that workers who earn income in the state pay their fair share of the state tax burden for the benefits and protections that the state provides to them." *Id.* I further noted that "[t]he states' legitimate interest, however, must be balanced against the burdens that are imposed on multistate enterprises, and on the conduct of interstate commerce, by uncertain, inconsistent, and unreasonable withholding obligations imposed by the states." *Id.* I concluded:

> In the end, although there may well be room for additional fine-tuning of the statutory language to assure that the right balance is struck between the states' legitimate interests in revenue raising and the nation's interest in preserving our national common market, I believe that a targeted response to the specific problem reflected in the proposed [legislation] is an appropriate exercise of the congressional commerce power.

Id. at 10.

the legislation's stated goals of "fairness" and "simplification,"[39] it will need to address each problem in the particular context in which it arises with a sensitivity both to the broad tax policy concerns at issue as well as the extremely significant issue of state tax administration, which may vary from context to context.

B. Sales Taxes Are Different From Income Taxes and So Are the Nexus Issues Associated with Those Taxes

My second point is related to my first, and I do not believe its importance can be overstated, in part because there is a tendency to elide the nexus issues raised by sales taxes with those raised by income taxes and, in my view at least, the issues may be different.

Let me begin by describing the context of the sales tax "nexus" issue, because I think it is necessary to make my point. When states first enacted sales taxes during the Depression, they faced the problem that they would lose revenue and their merchants would lose business, if their residents shopped in neighboring states without sales taxes (or with sales taxes with lower rates). Under the judicially articulated restraints imposed on the states under the Commerce and Due Process Clauses, it has always been clear that one state may not impose a sales tax on a sale that occurs in another state. To address this problem, states enacted use taxes.

A use tax is imposed on the use, storage, or consumption of tangible personal property and selected services in the state. It is functionally equivalent to a sales tax. It is imposed with respect to the same transactions and at the same rates as the sales tax that would have been imposed on the transaction had it occurred within the state's taxing jurisdiction. However, because the use, storage, or consumption of property or services within the state are subjects within the state's taxing power, there is no constitutional objection to the imposition of such a tax[40] – as there would be with regard to a tax on an out-of-state sale.

In principle, then, an in-state consumer stands to gain nothing by making an out-of-state or interstate purchase free of sales tax, because he will ultimately be saddled with an identical use tax when he uses, stores, or consumes the property or services in his home state. If, for example, a Washington resident were to go to Oregon to purchase a car, she would pay no sales tax in Oregon, which does not tax sales, but she would pay use tax in Washington, when she went to register her car, equal to the sales tax that she would have paid had she bought the car in Washington. Every one of the 45 states and the District of Columbia that has sales taxes also imposes complementary use taxes.

In theory, the basic sales/use tax regime that I have just described applies to mail-order sales or to sales over the Internet in the same manner that it applies to transactions

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[39] *See supra* note 8.

[40] *See Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937) (sustaining constitutionality of state use tax scheme).

involving automobiles. Thus, if I buy a book from Amazon.com, and it is shipped to me in Athens, Georgia, there is no question that I will owe a Georgia use tax equal to the sales tax that I would have paid had I bought the book in a local bookstore in Athens.

There is, however, one significant difference between the purchase from Amazon.com and the purchase of the automobile I described above. With respect to the purchase of the automobile, the state has a practical means of requiring the purchaser to pay the use tax – namely, collecting it upon registration of the vehicle. But states do not require that consumers register books they purchase (and presumably will not be able to do so long as we have a First Amendment). Consequently, unless the consumer voluntarily remits the use tax on the purchase from the out-of-state vendor, which consumers rarely do notwithstanding their legal obligation to do so, the state has no practical means for collecting the use tax unless it can require the out-of-state vendor to collect the use tax in the same way that it relies on the in-state vendor to collect the sales tax. As the previous discussion makes clear, the state cannot do so unless the out-of-state vendor has "nexus" in the state.

The question for Congress, then, is what *should* be the nexus rule in this context? First, one might ask whether, apart from administrative concerns, there is any sales tax policy that would justify exempting sales by remote vendors from tax while imposing such a tax on sales made by local retailers. I can tell this Subcommittee with confidence that there is none, unless one wants to encourage shopping from remote rather than local sellers. There is virtually unanimous agreement among tax policy experts that a good consumption tax applies equally to all taxable consumption in the state and, since we know that the item purchased from a remote seller is just as taxable as the same item purchased locally, there is no policy justification, apart from administrative concerns, for allowing the former but not the latter to go untaxed. Indeed, unless the administrative burdens on out-of-state vendors of complying with the state's sales tax regime exceed those on in-state vendors by an amount equal to the tax, the rule of *Quill* operates like a subsidy for shoppers to purchase goods from vendors with no physical presence in the state.

In short, the *only* nexus question in the sales and use tax context is under what circumstances it is reasonable to require an out-of-state vendor to act as an agent to collect the tax in light of administrative concerns. Is it reasonable to make that turn on the question whether the vendor has a physical presence in the state, or has a particular threshold of sales in the state, or is incurring (or is likely to incur) greater tax compliance costs, or on some other criterion? I return to that question in a moment. My purpose here is simply to identify what the nexus problem is in the sales and use tax context.

In the income tax context, we have a different and more complex problem. In contrast to the sales tax context where we know that a tax is due and the only question is whether we can find some reasonable method of enforcing collection of it, there is a serious question (about which reasonable people can and do differ) whether there should be *any* tax liability for income (or, at least, income from business activities) unless and until one has exceeded a certain threshold of activity in the state. This is a problem that has an international as well as subnational dimension with extensive debate over how one should

Mr. COHEN. Thank you, Professor Hellerstein. Appreciate it.

Second witness, Mr. Joseph Crosby. Mr. Crosby is the senior director of policy of the Council on State Taxation and its chief operating officer.

He regularly testifies before State legislatures and other State and national policy-making boards, such as the Federal Advisory Commission on Electronic Commerce, and frequently quoted in State and local tax policy publications. Previously served this organization as legislative director.

Prior to joining COST, Joe was national director of the State legislative services for Ernst & Young in Washington, D.C.

Mr. Crosby, thank you very much, and we—you may begin your testimony.

TESTIMONY OF JOSEPH CROSBY, LEGISLATIVE DIRECTOR, COUNCIL ON STATE TAXATION

Mr. CROSBY. Thank you, Mr. Chairman, Members of the Committee. I appreciate the opportunity to share with you today COST's views on the important issue you have before you, the role of Congress in defining tax nexus.

Council on State Taxation, COST, is a trade association based here in Washington, D.C. We represent approximately 600 of the Nation's largest businesses on State and local tax issues.

In my written statement, I demonstrate two things. First, that the existing hodgepodge of State tax nexus laws burden interstate commerce; and second, that Congress has a responsibility to regulate issues associated with State tax nexus.

In the interest of time, I am going to focus my comments on the second part of that, which is the need for Congress to act.

Nexus laws very widely and are constantly changing. Over the past few years, the pace of change has accelerated, and new laws and regulations are directed almost exclusively at expanding the jurisdiction of State tax nexus.

These expansive nexus standards have implicated many areas of State taxes, including personal income taxes, business activity taxes, sales and use taxes, and telecommunications transaction taxes.

The fact that States have been very active over the past few years in adopting new and amended laws and regulations has not provided taxpayers with either clarity or certainty.

Indeed, clarity and certainty are not the motivations for the enactment of these laws. The primary motivation for expanded State tax jurisdiction, as the Chairman indicated in his opening remarks, is to bring in more tax revenue to the States. It is quite natural for State legislators to seek to export their tax burdens to the greatest extent possible.

Even if the States did have a desire to provide clear and certain nexus standards, though, they cannot do it. They can't do it because State tax jurisdiction is ultimately a constitutional construct.

States acting alone or even in concert cannot usurp the Constitution. And so ultimately it falls on this body to determine the appropriate extent of State tax jurisdiction.

With regard to nexus for business activity taxes, absent Federal action the controversy that exists today will continue unabated. It imposes significant burdens on our national economy.

Since Quill was decided by the court nearly two decades ago, the court has had many opportunities to take State tax nexus cases and has chosen not to do so. Even if the court were to decide to take a case, it is likely that it would be decided on the limited facts of the case. Quill has taught us this.

As Professor Hellerstein noted, even if the court were to take such a case, the Congress still ultimately has the authority to determine the appropriate extent of State tax nexus.

Congressional legislation clarifying that physical presence is the appropriate nexus standard for the imposition of direct taxes on business is fair to both States and businesses and provides predictability and consistency necessary to promote economic growth.

Turning to sales and use taxes, the States and the business community have actually come together in this area. Mr. Delahunt was here briefly earlier. He has long worked on this issue.

The States and the business community over—for over 10 years have worked together on the Streamlined Sales and Use Tax Act to address the burden issue that the court spoke to in Quill. Unfortunately, that process cannot come to resolution absent congressional action.

The process was initially predicated on congressional enactment of authorization of States to collect sales taxes, coincident with Federal legislation that demonstrated—required the States to simply, that compensates sellers for any burdens that remain, and that make sure that there is a fair and even nexus standard that applies nationwide.

Finally, turning to non-resident taxation of employees and telecommunications taxes, the problems in these areas are not necessarily the case that tax jurisdiction isn't clear. For non-resident employees who travel to multiple States, it is clear that States have nexus over these folks and can impose tax on them.

The question is whether the multiplicity of jurisdictions that have the ability to tax the same income makes sense in our national economy. And as the Federation of Tax Administrators said in testimony before this Committee in a prior Congress, "Complying with the current system is indeed difficult and probably impractical."

A Federal solution to the issue of non-resident personal income taxes and telecommunications transaction taxes can be crafted without imposing financial hardships on the State and without unduly interfering with State tax authority.

It is conceivable in these areas that the States acting in lockstep could address the problem. The reality is, however, we have no example in our history of the States coming together on a tax issue like this to create and continue uniformity over any period of time.

In conclusion, I urge this Committee to favorably report the legislation that is before it. It is critical that the Congress have a thorough debate on these issues, and I applaud the Chairman and the Ranking Member for holding this hearing today.

I welcome any questions that you or the Committee may have. Thank you very much.

[The prepared statement of Mr. Crosby follows:]

PREPARED STATEMENT OF JOSEPH R. CROSBY

Testimony of

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On the Issue of

State Taxation: The Role of Congress in Defining Nexus

Before the

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

February 4, 2010

Mr. Chairman and Members of the Committee, I am Joe Crosby, Chief Operating Officer and Senior Director of Policy for the Council On State Taxation, which is more commonly known as COST. I appreciate the opportunity to share with you COST's views on the important issue that you have before you—the role of Congress in defining nexus.

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

In my testimony today, I hope to answer two questions:

- Does the existing hodgepodge of state tax nexus and related laws burden interstate commerce?
- Why should Congress debate issues associated with state tax nexus?

Unclear State Tax Nexus Standards Burden Interstate Commerce

State tax nexus laws and regulations vary widely and are constantly changing. Over the past few years, such changes have been directed almost exclusively toward extending the reach of state tax jurisdiction. State legislative and regulatory efforts to expand state tax jurisdiction have implicated many different areas of taxation, including personal income taxes, business activity taxes (e.g., corporate net income taxes), sales and use taxes and telecommunications transaction taxes. Due to the serious fiscal shortfalls facing states, the pace of these changes is accelerating. The existing hodgepodge of state tax nexus and related laws burdens interstate commerce in many ways.

Personal Income Taxes[1]

In its 1992 *Quill* decision, the U.S. Supreme Court noted that imposing a use tax collection requirement on every vendor who advertised in a state three times a year would unduly burden interstate commerce, particularly in light of the more than 6,000 potential taxing jurisdictions. Today, we are looking at similar situations involving the potential of filing returns in multiple jurisdictions under ambiguous, complicated and burdensome requirements. For example, every day in our country, thousands of Americans travel outside their home state on business trips for temporary periods. States currently have widely varying and inconsistent standards regarding the requirements:

- for *employees* to file personal income tax returns when traveling to a nonresident state for temporary work periods; and,
- for *employers* to withhold income tax on employees who travel outside of their state of residence for temporary work periods.

Employees who travel outside of their state of residence for business purposes are subject to onerous administrative burdens because, in addition to filing federal and resident state income tax returns, they may also be legally required to file an income tax return in every other state into which they traveled, *even if they were there for only one day*.

In one celebrated case, a taxpayer paid state and local income taxes to the two states in which he lived during 2003-6. The taxpayer should have paid taxes to the two states in which he lived plus *fifteen* additional states to which he traveled and in which he worked.[2] The diffence between the tax that was paid to the two resident states and what should have been paid to all seventeen states was less than one half of one percent. One can surmise that the legal and accounting fees associated with filing more than two dozen additional tax returns in those states over the four-year period and the amended returns the taxpayer needed to file in his resident

[1] *See, e.g.*, H.R. 2110, "Mobile Workforce State Income Tax Fairness and Simplification Act," 111th Cong., 1st Sess. (April 27, 2009) and H.R. 2600, "Telecommuters Tax Fairness Act of 2009," 111th Cong., 1st Sess. (May 21, 2009).

[2] Curtis Gilbert, *Accountants: Franken's tax problems should have been caught*, Minnesota Public Radio (May 2, 2008); document summarizing tax payments on file with author.

states to claim credits for taxes paid to the nonresident states dwarfed the approximately $1,000 annual net "gain" to state tax authorities.

In other instances, employees who live and work in one state, but who travel to their employers' headquarters in another state for temporary work periods, have been compelled to pay tax on their *entire* wages for the year to the nonresident state. Such policies impose not only administrative burdens on these employees but also the substantial burden of multiple taxation of their income.

The burden of these taxes also falls on employers, which are required to incur extraordinary expenses in their efforts to comply with the states' widely divergent withholding requirements for employees' travel to nonresident states for temporary work periods. According to the Federation of Tax Administrators, "Complying with the current system is…indeed difficult and probably impractical."[3] Congressional adoption of a national, uniform threshold for the taxation of nonresident workers is urgently needed.

Business Activity Taxes[4]

Changes in the economy over the last few decades have dramatically reduced the barriers to engage in interstate commerce for companies of all sizes, and thus the problems associated with this longstanding uncertainty over state business activity tax nexus continues to grow. The uncertainty created by conflicting interpretations of the Constitutional nexus standard for business activity tax jurisdiction results in unnecessary administrative and litigation expense for both taxpayers and states. As interstate commerce continues to grow, so will these expenses. Furthermore, as recently recognized by the American Bar Association's Task Force on Business Activity Taxes and Nexus, such uncertainty also increases the risk of multiple taxation of the same income and makes business planning extraordinarily difficult.

[3] Statement of Harley Duncan before the House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, November 1, 2007.

[4] *See, e.g.*, H.R. 1083, "Business Activity Tax Simplification Act of 2009," 111th Cong., 1st Sess. (Feb. 13, 2009).

Left to their own devices, the states have enacted a hodgepodge of widely varying (and often not clearly articulated) business activity tax nexus laws and regulations.[5] State tax administrators may claim that clarity and certainty could be achieved if all states were to agree to change their laws to adopt formula-based approaches, such as the Multistate Tax Commission's "factor presence nexus standard," but such claims miss the mark.[6] Taxpayers are rightly unwilling to pay taxes to states which have no Constitutional authority to impose taxes on them. Nearly two decades of costly litigation has failed to provide any clarity in this area. Absent guidance from Congress, taxpayers can never be certain whether these expansive nexus statutes would pass Constitutional muster.

The administrative burden of expansive state tax nexus standards continues to increase. Financial Accounting Standards Board Interpretation 48 (Accounting for Uncertainty in Income Tax) of its Statement 109 (Accounting for Income Taxes)—known as FIN 48—shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards.[7] FIN 48 seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes. However, the lack of any national, definitive authority for state business activity 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 tax nexus in a state and thus does not file a return there, the statute of limitations for an assessment 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 taxable nexus, the business may be unable to reach the required

[5] *See, e.g.*, Florida: selling or licensing the use of intangible property (i.e.: tradename, trademark, patent) constitutes doing business in the state Fla. Admin. Code Ann. R 12C-1.011(1)(p); Iowa: a taxpayer whose sole connection with the State is maintaining intangible property is deemed to be "doing business" Rule 701-52.1(4); Michigan Business Tax (MBT) a taxpayer, other than an insurance company, has nexus with the state "…if the taxpayer actively solicits sales in this state and has gross receipts of $350,000 or more sourced to this state." MCL § 208.1200 (1); New Hampshire: "business activity" in the state includes "employment of business assets, the receipt of money, property, or other items of value…" New Hampshire §77-A:1.XII; Oregon: a taxpayer is "doing business" when it engages in any profit-seeking activity in the state OAR §150-317.010(4)(1).

[6] Multistate Tax Commission, *Factor Presence Nexus Standard for Business Activity Taxes* (Oct. 17, 2002). "Substantial nexus" is established with a state if any of the following thresholds are exceeded in a jurisdiction: $50,000 in property, or $50,000 in payroll, or $500,000 in sales, or 25% of total property, total payroll or sales.

[7] FIN 48 was recently renamed "FASB ASC 740-10," but tax practitioners have grown fond of FIN 48 (as a moniker, at least).

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 taxable nexus or unless the business capitulates and pays the taxes to avoid this uncertainty. This is but one example of how the current uncertainty over the extent of state tax jurisdiction creates confusion beyond the immediate tax effects.

The uncertainty of the nexus standard for business activity taxes also has implications for the United States' foreign relations. 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. Permanent establishment is defined generally as a fixed place of business through which the business of an enterprise is wholly or partly carried on.[8]

Foreign businesses are often shocked to learn that while treaties may insulate them from federal taxation, state taxes can still be imposed on them. This factor, when combined with the ambiguity of current state tax nexus law and the aggressiveness of state tax administrators, may put a damper on foreign investment. The increasing divergence between the federal/international and state standards for business activity tax jurisdiction could prompt protests or retaliation by foreign governments and/or foreign corporations. Indeed, a senior Treasury Department official, prior to assuming that role, voiced concerns as to the potential international ramifications of assertions of expansive tax jurisdiction by the states.[9]

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[8] Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, Articles 5, 7 (Jan. 28, 2003).

[9] *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):

> [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 [permanent establishment)] standard.

Congressional legislation clarifying that physical presence is the appropriate nexus standard for the imposition of direct taxes on business is fair to both states and businesses and provides the predictability and consistency necessary to promote economic growth and responsible business planning.

Sales and Use and Telecommunications Transaction Taxes[10]

In the area of sales and use and telecommunications transaction taxes, two separate nexus questions arise: does the state have nexus over the transaction and does the state have nexus over the seller of the product or service to require them to collect the state's tax? On the latter question, the U.S. Supreme Court has offered a 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 *Quill*, the U.S. Supreme Court reaffirmed an earlier holding (*Bellas Hess*) by reiterating its bright line rule that a state cannot impose a sales tax collection obligation on a seller that does not have a physical presence in the state.

Unfortunately, this bright line rule has not provided sellers with the certainty one might have expected. States continually seek to narrow the impact of the *Quill* decision. As part of these efforts, many states have adopted new laws that assert that sellers without physical presence in a state have nexus by virtue of the activity of another party.[11]

These laws put many sellers in an untenable position. If a seller refuses to collect the tax, and a court later determines the law to be Constitutional, then the seller must pay the tax without any real recourse to collect the tax from its customers. If the seller collects the tax, then it may be subject to class action litigation on behalf of customers who argue that the seller is not required to collect the tax. Many individuals are also harmed by these laws. State residents receiving revenue from providing links (advertising) to remote sellers stand to lose that revenue when

[10] *See, e.g.*, H.R. 3396," Sales Tax Fairness and Simplification Act," 110th Cong. 1st Sess. (Aug. 3, 2007).

[11] *See, e.g.*, so-called "Internet nexus" proposals: New York State S.6807-C/A.9807-C, enacted April 2008; Rhode Island HB 5983Aaa, enacted June 2009; North Carolina SB 202, enacted August 2009. Approximately half a dozen states legislatures have similar proposals under consideration thus far in 2010.

remote sellers eliminate these programs to avoid having nexus asserted. Several large Internet sellers have pulled out of states for exactly this reason.[12]

The states and the business community have come together to address the undue burden on interstate commerce identified in the *Quill* decision. The Streamlined Sales and Use Tax Agreement reduces the complexity businesses face in collecting sales and use taxes in more than 6,000 disparate jurisdictions. Absent Congressional support, however, nearly 10 years of cooperative efforts between the states and the business community will never produce its expected fruit; the project was predicated upon eventual Congressional authorization of state collection authority. Uniform collection can only come with Congressional legislation that supports radical simplification of the sales and use and telecommunications transaction system, provides reasonable compensation for the remaining costs sellers incur in collecting these taxes and establishes a state tax nexus standard that treats all businesses equally.

Questions regarding which states have nexus over a transaction often arise with respect to interstate transactions where different aspects of the sale of a product or the provision of a service can be viewed as taking place in more than one state; the issue is generally whether a particular state is entitled to impose its tax on the full amount of the price charged. This issue has been addressed by the U.S. Supreme Court in the context of interstate wireline long distance telephone services (*Goldberg v. Sweet*) and interstate bus transportation (*Jefferson Lines*). Congress addressed this issue with respect to wireless telecommunications services in the Mobile Telecommunications Sourcing Act by granting states the right to tax the entire charge to a customer for mobile telecommunications at the customer's "place of primary use." The same issue is now arising in the taxation of mobile Voice over Internet Protocol (VoIP) services. Since the cutomer is able to use this service in any jurisdiction (including foreign countries) at any time, which state has the right to tax the monthly recurring charge to the customer? States are generally unable to solve issues that have been created by these new technologies due to the uncertainty regarding whether states have jurisdiction to tax transactions that occur wholly outside of their borders. Congressional legislation to provide clear guidance regarding nexus

[12] *See, e.g.*, Saul Hansell, "Overstock.com Throws New York Affiliates Overboard to Avoid Sales Tax" (New York Times, May 14, 2008).

over the transaction is needed for mobile VoIP service in essentially the same way that it was needed for wireless telecommunications services. However, this issue should not be confused with nexus over the seller, which was at issue in *Quill* and which requires radical simplfication of the sales and use and telecommunications transaction tax systems.

Congress Must Debate the Proper Extent of State Tax Jurisdiction

The fact that states have been very active over the past several years in adopting new and amended laws and regulations defining the extent of their tax jurisdiction has not furthered clarity or certainty. Indeed, clarity and certainty are not the motivations behind any of these laws. The primary motivation for expanded state tax jurisdiction is to generate additional tax revenue from individuals and businesses with minimal connections to a state. In other words, states are quite naturally attempting to export their tax burdens to the greatest extent possible.

Even if the states had a desire to provide taxpayers with clear and certain state tax nexus standards, they cannot do so. The extent of state tax jurisdiction is ultimately governed by the Constitution. No action by a state or a group of states can provide clear state tax nexus standards. Even if all of the states joined together and created a single, uniform state tax nexus standard, uncertainty would still reign: this uniform law itself would remain subject to the constraints of the Constitution. Absent federal guidance, the limits of state tax jurisdiction will always be uncertain.

The U.S. Supreme Court's *Quill* decision was 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."

Congress, accordingly, as the ultimate authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but also the responsibility to ensure that interstate commerce is properly regulated (including taxation of such commerce).

All would agree that tension exists between a state's authority to tax and the authority of Congress to regulate interstate commerce. Clearly, one size does not fit all in this area. Congress may well determine that the appropriate state tax nexus standard for the imposition of a tax—such as a business activity tax—is different than that for the imposition of an obligation to collect a tax from others—such as the sales and use tax.

With regard to nexus for business activity taxes and sales and use taxes, absent federal action, controversy will continue unabated. This controversy imposes significant administrative and financial burdens on the national economy. The U.S. Supreme Court stated in *Quill* that state tax nexus is an issue for the Congress. Since that decision nearly two decades ago, the U.S Supreme Court has not taken any of the many state tax nexus cases presented to it. Even were the U.S. Supreme Court to take a case involving state tax nexus, it is unlikely that the Court's decision would provide guidance beyond the limited facts in the case; *Quill* has proved thus.

In other areas, such as the taxation of nonresident employees, the problem is not necessarily that the extent of tax jurisdiction over the employee is unclear. The concerns here stem from the multiplicity of jurisdictions that have the authority to tax the same income. Similarly, in the case of telecommunication transaction taxes, tax jurisdiction over the seller may not be in doubt. Rather, it may be unclear which states have nexus over the individual transactions. Consequently, these issues may dictate yet different state tax nexus standards.

Support for a federal solution to the problems associated with both the taxation of nonresident employees and the taxation of VoIP services is premised upon a desire for a national, uniform, simple and fair manner to tax these individuals or transactions. Solutions can be crafted in both of these areas that solve the current problems without imposing financial hardships on the states and while minimally intruding on state tax authority. It is conceivable that the states, acting in lockstep, could address these issues without support from the federal government. But,

in reality, there is no example of successful cooperative state action of the kind required. Without Congressional action, the problems in both of these areas will persist. Ultimately, for both the taxation of nonresident employees and telecommunication transaction taxes, a national law will provide benefits to employees, employers, consumers, telecommunication providers and the states.

Conclusion

Expansive state tax nexus standards impose substantial burdens on interstate commerce. The Constitution vests in Congress the authority and the responsibility to regulate interstate commerce, and the U.S. Supreme Court has said that the appropriate extent of state tax jurisdiction is ultimately for Congress to decide. The proper solutions to the various issues before this Committee may differ, but it is the Congress that must propose and seriously debate such solutions. Unless the Congress acts, these problems will remain unsolved and are likely to worsen.

I urge the Committee to favorably report to the Judiciary Committee the legislation addressing state tax nexus that is before it. We are very interested in working with this Committee and other interested parties to continue to refine these proposals. Without action by this Committee, however, meaningful debate regarding the appropriate extent of state tax jurisdiction cannot occur.

Mr. Chairman, I again thank you for the opportunity to speak before this Committee today. I welcome any questions that you or the Committee members may wish to pose.

Mr. COHEN. You are welcome, Mr. Crosby, and a wonderful close.

Our final witness is Mr. Bruce Johnson. Commissioner Johnson was appointed to serve as commissioner of the Utah State Tax Commission by Governor Leavitt in October 1998. December 2009, Governor Herbert named him chair of the commission.

The tax commission is comprised of four commissioners who have the constitutional duty to administer and supervise all the tax laws of the State of Utah, including property tax, income tax, franchise tax, sales tax and other miscellaneous taxes.

Prior to his appointment, Commissioner Johnson was a partner in the law firm of Holme Roberts & Owen. And prior to joining that firm, he was a trial attorney for the tax division of the U.S. Department of Justice.

Thank you, Commissioner Johnson, and we welcome your remarks.

TESTIMONY OF R. BRUCE JOHNSON, COMMISSIONER, UTAH STATE TAX COMMISSION

Mr. JOHNSON. Thank you, Mr. Chair and Members of the Committee. It is a great pleasure for me to be here today.

It is particularly an honor to testify with Professor Hellerstein. I learned a lot from his father's textbook. I continue to consult his textbook.

It is also a pleasure to appear with Mr. Crosby. I worked with COST extensively over the last 12 years, and I think we have had the opportunity to make some progress on some of these difficult State tax issues.

I am appearing today on behalf of the Federation of Tax Administrators, which is a group of tax agencies across the country. It is all 50 States, the District of Columbia and New York City.

Nexus is a fundamental concept in State taxation and it benefits both taxpayers and tax collectors. It is rooted in the fundamental laws of the country—in the Constitution, as interpreted by the courts, as Professor Hellerstein has noted.

Mostly, Congress has chosen to forbear from limiting—from exercising its ability to limit the States, and we urge that forbearance to continue.

There are times in the past when the States and businesses have come together and recognized that they need a congressional solution, and that has been forthcoming, and we appreciate the Congress' forbearance on these important issues.

The basic issue before us really is is economic presence appropriate or is physical presence the appropriate test for nexus. I would agree with Professor Hellerstein that this is not a situation in which one size fits all. But the basic question is physical presence versus economic presence.

And the fact is that the economy of the 21st century is electronic and borderless. Many multistate businesses can and do operate without any physical presence in a State. They exploit the State's market. They make millions or hundreds of millions of dollars of sales into those States and derive income from those States.

Consequently, the businesses that utilize these modern technologies may have less of a physical presence in the State, but they have a much greater impact on the State and on a State's economy. Appropriate nexus standards need to take that into account.

Let me give you a couple of real quick examples. I have a couple of credit cards in my wallet, one of them from a local bank. One of them is from a bank that is headquartered in the east.

Let's assume both of those banks have $10,000—or 10,000 customers in the State of Utah. Let's assume they both receive the same amount of revenue from bank charges from stores in the State of Utah. Let's assume they both receive exactly the same amount of interest income from Utah cardholders.

Does it make sense that one bank has to pay income tax on all of that money and the other bank doesn't? Why should an out-of-state bank be able to come in, exploit the Utah market, and not have to pay an income tax on the income it derives from the Utah market? It simply doesn't make sense in this economy.

Another example—one of my favorite bookstores—actually, my favorite bookstore in Salt Lake is Sam Weller's Bookstore. My grandmother used to buy books there before I was born. She brought me a book every year on my birthday.

My other favorite bookstore is Amazon. Amazon sends me e-mails two or three times a week that tell me what I have ordered, what I have browsed, what my favorite choices are, what books they think I would like, and I have some of those downloaded onto my Kindle in about 20 seconds.

Does it make sense that Sam Weller has to collect sales tax on the sales of books to me and Amazon, who knows a heck of a lot more about me than Sam Weller does, frankly, doesn't have to collect a sales tax?

The fact is that the physical presence standard was outmoded and recognized as outmoded by the court in Quill in 1992 and was affirmed on the basis of stare decisis. It was outmoded, you know, 18 years ago and commerce has changed radically since then.

This is simply a—the physical presence standard is a relic of a bygone era and should be rejected.

The other point I would like to make is—two other points I would like to make. This is not a question of States—hungry States versus businesses.

This is a question of taxpayers within the State versus taxpayers that are multistate businesses. How is the burden appropriately and fairly distributed among all of the people, all of the businesses doing business in the State? It is a fairness issue.

The States gave up a lot of their sovereignty when the Constitution was adopted. And they did it for good and appropriate reasons. But because they did give up that important part of their sovereignty, it is important that this Congress recognize and deal very carefully in this area.

Thank you very much.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF R. BRUCE JOHNSON

Statement of

R. Bruce Johnson
Chair, Utah State Tax Commission
Appearing on Behalf of the
Federation of Tax Administrators

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

February 4, 2010

Hearing: State Tax Nexus

Statement of
R. Bruce Johnson
Chair, Utah State Tax Commission
Appearing on Behalf of the
Federation of Tax Administrators

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

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear before you today. My name is Bruce Johnson. I am currently the Chair of the State Tax Commission of the State of Utah and I appear before you today representing tax administrators across the country whose agencies are members of the Federation of Tax Administrators. The Federation is an organization of the state tax agencies of the all of the fifty United States, the District of Columbia and New York City.

You have asked me to discuss the general issue of nexus in the context of state taxation, i.e., the necessary connection or relationship that must exist between a taxing jurisdiction and the taxpayer it may seek to tax. Nexus is a fundamental concept that benefits both the tax payers and tax collectors of this country. It is a concept of fundamental fairness rooted in the basic law of this country, the Constitution of the United States of America, as interpreted by the Courts and as implemented by the statutes enacted by the legislative bodies in this country. Certainly the Congress can and, in rare instances has, legislated in the area of nexus for taxation by the states and their political subdivisions. Mostly the Congress has chosen to forbear from limiting the ability of the states to impose lawful taxes and it is that thoughtful forbearance from limitations that I urge you to continue.

There are pending in this 111th Congress several proposals that would mostly negatively impact the ability of the states to collect their taxes. A few would enable the states to better collect taxes and these, of course, are worthy of your favorable consideration. I have attached a list of this legislation to my testimony in the hope that it would aid you in your deliberations.

State tax nexus has a long and interesting history in American jurisprudence and legislation. You have heard from an eminent academic legal authority on this concept in the person of Professor Walter Hellerstein. Professor Hellerstein has written about these issues as well as represented business clients on these matters for years. I will not cover the same ground nor seek to compete with Professor Hellerstein's scholarship.

Suffice it to say that the economy of the 21st Century is electronic and borderless. Most multistate businesses can and do operate anywhere and anytime without the encumbrance of physical presence. Technological developments have completely reshaped the manner in which business is conducted; both for businesses that make and sell things and those that develop and sell services. Consequently, the business that utilizes modern technology to penetrate and exploit a state's market, while it may have less of a physical presence in the state than the locally established business, may have more of an impact on a state's economy. Reasonable nexus standards must take that into account.

That is why the current nexus standard for sales tax collection, requiring a physical presence to justify taxation, is not appropriate in the new millennium for either sales taxes or income taxes. Economic presence, taking into account appropriate apportionment formulae, is the fair way to establish basis for collection and payment of tax. Fairness is the pre-eminent principle that should inform our tax policy, for it is fairness as well as the perception of fairness that underlies voluntary compliance, which is the basis for collection of most taxes in this country. A physical presence should be abandoned for sales taxes and not even considered for income or business activity taxes. Requiring a physical presence before a business can be required to collect sales or use

taxes was adopted by the Supreme Court almost 43 years ago[1]. It was reaffirmed by the Court in 1992, but even then the Court recognized that it was an anachronism, and that the standard may have been rejected if brought for the first time. "While contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today, *Bellas Hess* is not inconsistent with *Complete Auto* and our recent cases.[2] The physical presence test is a relic of a bygone era and fails to recognize the realities of commerce in the 21st Century. Such a standard has not been adopted by the Court for income or business activity taxes. The Court specifically said in *Quill*: "Although we have not, in our review of other types of taxes, articulated the same physical presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." [3] To assert that it should be the standard for income or business taxes ignores the massive changes to the way that businesses operate. Taxpayers that operate in tax jurisdictions in competition with traditional businesses should pay their fair share. The playing field should be level. Congress should promote businesses operating on that level playing field, not tilt the field even more.

State tax nexus is a concept best understood by first looking at the relationship between the federal and state governments. While it is true that principles of due process may bear on state tax nexus, the precept that is central to and perhaps most controlling in this area is the Commerce Clause of the U.S. Constitution. While others here are speaking to the particular legal issues surrounding the concept of nexus, and how it applies and how it effects businesses, it is important that you also hear why the issue of nexus is so critical to the states and why the states look to Congress and to the federal government to deal fairly with this issue, taking into account the vital principle that the states should be given wide latitude in determining their own fiscal destiny.

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[1] *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967)

[2] *Quill Corp. v. North Dakota, By And Through Its Tax Commissioner, Heitkamp* 504 U.S. 298 (1992), 311.

[3] *Quill Corp. v. North Dakota, supra at 314.*

Before this nation was formally founded, inter-jurisdictional commerce was already an important force for economic growth and prosperity. North America was more isolated then, and while the trading of goods produced in remote locations throughout the territories was more difficult, that exchange was essential to the well-being of all of the territories and their citizens. The exchange of goods across territorial boundaries was generally welcomed, not hindered, but it was recognized that such boundaries could also constitute barriers to commerce.

Indeed, when the representatives of the various states came together to draft the Constitution, they shared a very important concern, that is, for the creation of a federal system that could effectively regulate commerce across state lines. They had lived for a short while under the Articles of Confederation, which failed to fully address this critical need, and they had seen the kinds of protective and retaliatory policies that states might adopt if not checked. It was out of this need that the Commerce Clause of the Constitution emerged, giving the federal government, and specifically, Congress, the authority to mediate state interests and create the foundation for a more harmonious and functional system of commerce throughout the United States.

It should not be forgotten that, in order to create this federal system, states gave up a part of their sovereignty over matters within their borders. This particular grant of sovereignty was no small thing. It involved a concession of power by the states in two essential areas, the power to regulate and the power to raise revenue. While a part of this sovereign authority now resides in the national government, that government cannot fairly exercise this authority without recognizing how significantly it may impact states and their ability to effectively govern. Throughout the history of this country, Congress has indeed recognized and respected the states and has been reluctant to preempt the authority of the states to govern, especially in the area of taxation, doing so only rarely. State tax administrators believe that Congress should continue to be very cautious and very thoughtful before it circumscribes the ability of the states to provide for the well-being of their citizens in ways best suited to them.

It is notable, therefore, that much of what we have to discuss with respect to the issue here today was handed down to the states, not by Congress, but by the Supreme Court. The U.S. Supreme Court has long recognized that in granting authority to the federal government through the Commerce Clause, the Constitution also implied a limit on the power that states retained over interstate commerce. This so-called dormant commerce clause doctrine means that authority to regulate commerce is not only vested in Congress, but at least to a degree, in the courts as well. Not every court, nor every judge, has been entirely comfortable with this authority.

Nor has the Supreme Court, throughout our country's history, interpreted and applied the dormant commerce clause doctrine consistently. For much of the early part of the last century, the Court's rulings, both in upholding and striking down various state regulations and taxes, turned on what we all now agree were very artificial distinctions. Eventually, the Court abandoned this line of reasoning, determining instead that there existed no general prohibition in the Constitution on the ability of states to regulate or tax interstate commerce. In the area of taxes, the Court now recognizes three general types of state laws prohibited by the dormant commerce clause: those that discriminate against interstate businesses, those that unduly burden interstate commerce and those that seek to extract a greater levy from out-of-state businesses than is fair. All other taxes on interstate commerce are permitted.

The jurisprudence has diverged somewhat on what creates nexus depending on the type of tax sought to be levied. As noted, if a state seeks to require a seller to collect and remit a sales or use tax, the Supreme Court in *Quill* has said that some physical presence of the putative tax collector must exist in the jurisdiction that seeks to require collection. At the same time, indeed in the same opinion, the Court emphasized that it was *not* announcing that physical presence is required before an income type tax can be levied. The application of the "physical presence test" to income taxes has been criticized, Professor John Swain at the University of Arizona School of Law and a co-author with Professor Hellerstein of their law school state and local tax casebook, has written a law review

article that "the physical presence nexus test motivates taxpayers to avoid physical presence in some jurisdictions while shifting property and payroll to tax havens."[4] Likewise, a Congressional Research Service analysis drew this conclusion regarding a physical presence test for tax nexus: "The new regulations as proposed"... in earlier congressional introductions..."would have exacerbated the underlying inefficiencies because the threshold for business would increase opportunities for tax planning leading to more nowhere income."[5]

How does the concept of state tax nexus, then, fit within the framework created by the Supreme Court? The Court has said that in addition to having a minimal connection with the state, to justify requirements of due process and give the state general jurisdiction over a person, where the imposition of a state tax is concerned, the person must also have a more definite connection, or "substantial nexus" with the state. This requirement is just one of the specific requirements set out by the court to ensure that state taxes are permissible under the dormant commerce clause. In addition, taxes must be fairly apportioned, must not discriminate against interstate businesses and must reflect the value of benefits provided by the state.

Exactly what will create substantial nexus sufficient for a state to impose tax on an out-of-state business under current Supreme Court standards may be subject to different interpretations. It is important to recognize, however, that the scope across which these interpretations range is a very narrow one. No reasonable person disputes, for example, that a business with employees, or offices, or inventory or equipment in a state has nexus in that state.[6] The Supreme Court has also clearly said that nexus may be created by

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[4] John Swain, "State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective," William and Mary Law Review, Vol. 45, Issue 1, 2003.

[5] Steven Maguire, *State Corporate Income Taxes: A Description and Analysis*, CRS Report for Congress, Order Code RL32297, updated June 14, 2006, p.16.

[6] Under PL 86-272, however, a state may have full-time employees in state, driving company cars on state roads, and still be beyond the reach of state income taxes. PL 86-272 was intended to be a temporary response to a shift in Commerce Clause interpretation by the Supreme Court. It didn't make any sense in 1959, when it was enacted. It makes even less sense now. Ideally, it should be repealed. At the very least, it should not be expanded. To do so would tilt the playing field even more against local businesses.

agents, as well as employees, working in a state if those agents help the business create a market in that state. In addition, a number of high courts in various states have held that where two companies are commonly owned and closely related and the nature of one of the affiliates is such that it must rely on the second for important functions, then the presence of that second affiliate in a state may create nexus for the first. On the other hand, it is also clear that under current Supreme Court standards, a state may not impose sales tax collection obligations on a business that has no connection to the state either through employees, agents, property or affiliations on which they depend to do business in that state.

It is this last aspect of the current Supreme Court standard which troubles the states. A business can regularly solicit customers in a state and even sell millions of dollars of goods into that state, directly competing with local businesses, but still avoid paying or collecting any sales or use taxes on its sales. Whether this result is justifiable depends on whether you believe complying with the state's sales tax laws would be an undue burden for such a business. However complicated the typical state sales tax might be, it is certain that most medium to large businesses regularly deal with other kinds of equally complicated obligations, including the obligation to pay federal income taxes and comply with federal regulations. The typical local retailer who regularly pays or collects the tax might be surprised to learn that the reason its larger out-of-state competitor can avoid collecting the tax is because that obligation has been deemed to be too great a burden. In truth, the current Supreme Court standard in this area is based on a fallacy – that a business could successfully solicit and succeed in selling to customers in a state, through use of effective and sophisticated modern means, such as mail order and the Internet, and without the need for face-to-face solicitation, and still not be able to handle collecting taxes for those sales.[7] It must also be said that the reason why states are so concerned about this issue is because the vast majority of the sales which are affected are likely to be taxable sales, a reality which also belies arguments that determining the tax due is just too complicated. The current standard has carved out a protected class of businesses from

[7] As noted above, the *Quill* opinion cast doubt on this conclusion, even as long ago as 1992. The conclusion is even more questionable in 2010.

all other businesses and granted to that class the privilege of avoiding a common obligation with which other, much less sophisticated and smaller businesses, have long complied.

To remedy what, in all candor, the states see as this failing of the current Supreme Court sales tax standard, the states are currently engaged in an effort to work with businesses to achieve sufficient simplification in their sales tax laws to convince the federal government that the burden of these taxes is not so great that they should be prohibited. Because it is uncertain how the federal government will ultimately respond to this effort, it is difficult for state law-makers to fully commit to this process, although many have already taken that risk. Regardless of whether this effort is successful in achieving its goal, it is not clear that the current Supreme Court standard can be sustained long-term. As new remote modes of commerce are more and more rapidly replacing the traditional modes based on storefronts and face-to-face dealings, it is hard to see how a favored class of non-taxable businesses can continue to be justified.

As you know, states are currently facing unprecedented challenges in balancing their budgets. According to the Nelson A. Rockefeller Institute of Government, the Public Policy Research Arm of the State University of New York, tax collections nationwide declined by 10.9 percent during the third quarter of 2009, the third consecutive quarter during which tax revenues fell by double-digit percentages. Combining current data with comparable historical figures from the U.S. Census Bureau, the Institute reported that the first three quarters of 2009 marked the largest decline in state tax collections at least since 1963. Western states saw especially sharp declines in tax collections during the third quarter, while revenues fell by more modest levels in the Southeast, New England, Mid-Atlantic, and Plains regions. For the fourth quarter of 2009, early data showed continuing declines, although the negative trend of the past year appeared to be moderating. For 38 early-reporting states, personal income taxes fell by 6.5 percent during October and November while sales tax collections declined by 5.5 percent.[8]

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[8] Lucy Dadayan and Donald J. Boyd, *Recession or No Recession, State Tax Revenues Remain Negative*, State Revenue Report, Nelson A. Rockefeller Institute of Government, January, 2010, No. 78

States have tapped their reserves and are involved in cutting spending for the foreseeable future. The federal government has provided substantial financial help to the states through the economic stimulus package. Because of the severity of the recession, and the fact that states cannot deficit spend, had it not been for this help from the federal government, state governments and the citizens they serve would be facing an even worse prospect in the coming year. It is a testament to the strength of our federal system, and the relationship between the federal and state governments, that we can cooperate at all levels to address a problem like the recent economic crisis.

What is as important, however, especially for the long-term, is that duly elected state legislators, after careful and thoughtful consideration of the needs of their own citizens and businesses, have the ability themselves to adopt the laws they think fair and that best serve their citizens and that they also have the ability to raise the revenue necessary to provide services and programs for their citizens. What the states seek, therefore, can be stated simply: a balanced federal policy that may prohibit discriminatory or unfair taxes on interstate commerce, but clearly allows states to require interstate businesses to pay their fair share. We believe this is what the drafters of the Commerce Clause envisioned and we have no doubt that it is achievable without coercive federal mandates.

Statement of Bruce Johnson to the United States House of Representatives, Committee on the Judiciary, Subcommittee on Commercial and Administrative Law,
February 4, 2010
Attachment 1

Federal Legislation Affecting State Taxation in the 111th Congress

1. State Estate Tax Credit

Legislation: S 722 and H.R. 4154 would extend the deduction state estate taxes, which would prevent the estate tax credit from coming back into the law in 2011 as it would along with pre 2001 tax rates and a $1 million estate tax exemption and 55% rate of tax, if current law is left unchanged.

2. Hotel Tax Preemption

Legislation: A proposal to preempt state and local hotel tax collections has been circulated but not yet introduced. The proposal would prohibit the imposition of hotel taxes on Online Travel Companies and travel agents.

3. Expanding Federal Refund Offset for State Tax Debts

Legislation: The State Tax Administration Assistance Act of 2009 (H.R. 2303) was introduced by the Chairman of the IRS Oversight Subcommittee of the House Ways and Means Committee, Rep. John Lewis (D-GA). The legislation would expand The Federal Refund Offset Program to include the debts of nonresident state taxpayers. The bill follows the preparation of a report recommending the expansion of the Program by the Government Accountability Office (GAO-09-571R Tax Refunds Offsets). A similar expansion was approved in the Senate in the 109th Congress and was included in draft legislation in the 110th Congress but not acted on.

4. Main Street Fairness Act-Streamlining of State Sales Taxes

Legislation: No legislation on streamlining of state sales taxes has been introduced in either the House or Senate in the 111th Congress, although similar bills have been introduced in prior Congresses. This is the legislation which would establish a nexus standard and procedure under which the states could require collection of sales or use taxes by sellers without the physical presence required under current interpretations by the Supreme Court.

5. Voice over the Internet Communications Taxation

Legislation: No legislation has been introduced, but a proposal developed by industry and government organizations for the Commercial and Administrative Law Subcommittee of the Committee on the Judiciary of the House has been circulated and discussed. Industry and FTA, along with other government organizations, disagree on one provision, dealing

with nexus. The point in contention is whether the bill should specify that these transactions create sufficient nexus to require the collection and remittance of state tax by the service provider. Technological and business imperatives suggest that a nexus provision is vital to the preservation of state tax bases.

6. Cable Video/Satellite State Taxation

Legislation: State Video Fairness Act (H.R. 1019). H.R. 1019 prohibits a "discriminatory tax," which is prohibited "if the net tax rate imposed on one means of providing multichannel video service is higher than the net tax rate imposed on another."

7. Cell Phone Tax Preemption

Legislation: The Cell Tax Fairness Act (H.R. 1521 and S 1192). The bill provides that "No State or political subdivision thereof shall impose a new discriminatory tax on or with respect to mobile services, mobile service providers, or mobile services property, during the 5-year period beginning on the date of enactment of this Act."

8. Mobil Workforce Withholding and Taxation

Legislation: The Mobile Workforce State Income Tax and Fairness Simplification Act of 2009 (H.R. 2110) would prohibit states from imposing an income tax on an employee (or a withholding obligation on the employer) unless the employee is a resident of the state or is present performing services in the state for 30 days or more in a calendar year. Generally, the employer may rely on the employee's reports of working time in various states. The states, through the FTA have agreed to work with the Multistate Tax Commission (MTC) Uniformity Committee on this issue to find a state solution.

9. Business Activity Taxes

Legislation: Business Activity Simplification Act (H.R. 1083) would require that a business have certain types of physical presence in a state before being subject to a state's business activity tax. The bills also substantially expand a 1959 law (P.L. 86-272) that protects certain solicitation activities from taxation by increasing the number and types of protected activities and expand the taxes subject to the P.L. 86-272.

10. Automobile Rental Taxation.

Legislation: H.R. 4175 would prohibit states or local governments from levying or collecting taxes on automobile rentals if the tax is not the same as that on a majority of other items of tangible personal property rented in a state.

Mr. COHEN. Thank you, Commissioner Johnson.

Normally, I start the questioning, but in recognition of the fact that we have reasonably good attendance and that Mr. Watt was so good to want to hear the witnesses and not do an opening statement, I am going to let Mr. Watt be the first person to ask questions.

Mr. Watt, you are recognized.

Mr. WATT. Thank you, Mr. Chairman.

I plead guilty to being the person who was rushing to hear the witnesses because I was hoping that the witnesses would shed a lot of light on this, and they have educated us substantially on the issues.

This is an issue that a number of us have been working on for a number of years, and it just seems to be like the little pink bunny. It keeps going and going and going. And it never gets resolved.

Mr. Johnson, there was a movement at some point to have the States come together and get a number of States to enter into some kind of streamlined agreement, compact, whatever. Can you tell us what the status of that is presently?

And because I am—there is a growing pressure to do something in this area because of the mismatch of—hodgepodge of things that is going on, and the pressures to do what you have suggested, which is stay out of this and do nothing, I think, are growing adversely to that position.

So tell us what is going on in that area and what is the impediment.

Mr. JOHNSON. Thank you. I appreciate that. The streamlined sales tax project is alive and well. We added our most recent State, Wisconsin, just in the last year. And this is one of those few areas in which we would ask Congress to act.

The business community and the States collectively have been working together to simplify their sales tax systems, to simplify their sales tax bases, to have more uniformity in the rates, more uniformity in the tax base among the various jurisdictions within a State——

Mr. WATT. Now, how many——

Mr. JOHNSON [continuing]. More uniformity——

Mr. WATT [continuing]. How many—Wisconsin made how many States that have come on board?

Mr. JOHNSON. I believe there are 21 States now that are full Members, and there——

Mr. WATT. Wasn't there some agreement at some point that once you reach some critical mass Congress would act, or at least that was implicitly understood? What was that magic number? And am I mistaken that there——

Mr. JOHNSON. Well, there was a magic—excuse me. There was a magic number before the agreement actually took effect, and we have reached that magic number. The magic number that is necessary before the Congress acts is a magic number that, frankly, is up to the Congress.

Mr. WATT. So what was the magic number that Congress didn't implicitly agree to?

Mr. JOHNSON. The magic number that was in place before the agreement became effective I think was 10 States with 20 percent of the population——

Mr. WATT. Okay, and——

Mr. JOHNSON [continuing]. Of the sales tax States.

Mr. WATT. Now, what would Congress need to do to move on that?

Mr. Crosby, you know about the history of this. What do we need to do? Or should we be doing nothing on that issue?

Mr. CROSBY. Thank you, Congressman Watt. First, in this current Congress, legislation has not yet been introduced. I know that is something that Mr. Delahunt and others have been working on. So critically, of course, to get legislation introduced—legislation that has been introduced in prior congresses that——

Mr. WATT. Which would do what?

Mr. CROSBY. Which would authorize States that have complied with the simplification requirements in the legislation to impose a collection obligation on all sellers regardless of nexus.

Mr. WATT. Okay.

Mr. CROSBY. So it would allow them to require these sellers to collect taxes under a simple sales tax system.

Mr. WATT. Now, would that solve the whole problem, or would this—is that just a particular segment of the problem?

Mr. CROSBY. It would address the problem with respect to sales and use taxes only. It would remain unsolved the issue of nexus for business activity taxes, the assignment of charges for telecommunications transaction taxes like voice over Internet protocol.

And then, finally, with regard to mobile workers, people who travel for business, there would still need to be relief provided for those who travel for——

Mr. WATT. And would that resolve at least that sales and use tax thing for all of the States or just for the 21 that have entered into the compact?

Mr. CROSBY. It would solve it for all of the States that chose to comply with it. So for the—those that have entered the compact, it would obviously—they would be almost all the way there.

Other States then could choose—and we know in talking with State legislators, there are many of them who have chosen not to act because until Congress acts that those—the remote sales dollars are not available to them, and so for many States there is a negative financial implication for acting now, and I know that has been the case in a number of States, including some of the States represented here.

Mr. WATT. Mr. Chairman, you rewarded me for not saying something, and I am—I hope you will reward me for being close to being—end of my time. So I will yield back.

Mr. COHEN. Thank you, Mr. Watt. I appreciate it. I will hold in reserve your reward.

Mr. Franks, you are recognized.

Mr. FRANKS. I usually go after you.

Mr. COHEN. If you would like to pass and we will recognize——

Mr. WATT. I have discombobulated him.

Mr. FRANKS. Yes.

Mr. WATT. He doesn't know how to react to it.

Mr. FRANKS. Mr. Watt does that to me a lot. If it is all right, I am going to pass over to Mr. Jordan.

Mr. JORDAN. Thank you, Mr. Chairman.

Mr. Johnson, is there anything in the example you gave, the two banks—is there anything prohibiting the bank in Utah from marketing their services and products out of State, or is there anything prohibiting—I think you said Sam's Bookstore versus Amazon—is there anything prohibiting Sam from marketing his product outside your State?

I mean, it seems to me we always have this idea to reach some sort of fairness, we have got to increase the tax burden on certain businesses who may be located out of the State versus there is other ways to be fair in the marketplace and for people to compete in the marketplace.

Mr. JORDAN. If those businesses—if Utah businesses—and many of them do—choose to exploit markets in other States, that is perfectly fine, and they should be subject to the taxation in those other States.

If those other States choose not to tax it, that is—that is their prerogative as well. But the States should have the authority to do that.

Mr. JORDAN. And, Mr. Crosby, you talk about the hodgepodge of laws and the idea that, you know, we need to tax more—or at least some think that—states think that—talk to me about what you would perceive as the burden on economic growth, particularly if we start putting an additional tax on cell providers, satellite providers.

It seems to me that—and particularly in this climate, economic climate, we find ourselves in, that would be the wrong approach.

Mr. CROSBY. Thank you, Congressman Jordan. The biggest problem, I think, is the considerable uncertainty that the business community faces today without an adequate answer as to when they are going to be subject to a State's tax jurisdiction.

Governor Gregoire in the State of Washington just last month proposed a bill that would say—would abandon Washington's long-held physical presence nexus standard and say you now have nexus if you sell into Washington. It would also say that if you stop selling into Washington you still have nexus for the next 4 years.

It is clear to me that in these cases the purpose of these bills is to export the tax burden, and that is a natural tendency, I think, for State legislators. And that, I think, is the role—and Chairman Cohen set it up very well at the beginning. At what point and how should Congress step in to make sure that the needs of the States are balanced with the needs of the national economy?

Mr. JORDAN. And you are representing briefly in your testimony—what about the impact on the individual? You know, I mean, to me, you know, obviously, at some point it is people paying these taxes, and the person who is traveling or whatever—talk about that.

Mr. CROSBY. Right.

Mr. JORDAN. I think that is a big concern.

Mr. CROSBY. It is a terribly large issue. Many of us—I mean, many of the folks here in this room today have traveled here. Washington, D.C., of course, doesn't have the right, as you well

know, to impose personal income taxes on non-residents. But every other State does.

Mr. JORDAN. Right.

Mr. CROSBY. Or every State does, I should say. And when individuals travel for business in many States today you are legally required to pay State taxes and, in some cases, local taxes even if you are there for 1 day.

Mr. JORDAN. Right.

Mr. CROSBY. The burden of that is, from an administrative perspective, on the individual and the employer—vastly exceeds the value to the economy. The legislation that Congressman Johnson has introduced addresses this in a very balanced way——

Mr. JORDAN. Right.

Mr. CROSBY [continuing]. And does so in a way that has almost negligible effect on most States financially.

Mr. JORDAN. I am a co-sponsor of that legislation.

Professor, what do you say about Congressman Johnson's legislation requiring you to be in a State for a certain period of time——

Mr. HELLERSTEIN. Yeah. I have actually testified on this issue before and I—in principle, I think that this is a very appropriate exercise of congressional power. Whether it should be 29 days or 25 days, you know, that is not——

Mr. JORDAN. Yeah.

Mr. HELLERSTEIN [continuing]. It is beyond my pay grade. But clearly, I think this is—in part for the reasons I think that have been suggested to the Subcommittee, this is a quite appropriate area for Congress to act.

Mr. JORDAN. And are you opposed—just for the record, are you opposed to Congressman Boucher's legislation, Professor?

Mr. HELLERSTEIN. Excuse me?

Mr. JORDAN. Congressman Boucher's—the BAT, the Business Activity Tax Simplification Act—are you——

Mr. HELLERSTEIN. No, I am not—am I opposed? I mean, no. And I have not—again, I am not here to either favor or disfavor any bills other than those I have already taken a position on.

If you ask me about—specifics about that bill, I would say—in effect, go back to my general point, which—it seems to me you have got to look very carefully at what it is—what is the context of an income tax.

Perhaps you might want to look at what other jurisdictions, including foreign jurisdictions, do. Should we have the same rules domestically as we have internationally? That is an important question.

I think you also have to ask the question whether or not, you know, where is the tax base. If, in fact, all the States are saying, often with businesses' encouragement, that the base should be defined entirely by sales, it might not make a lot of sense to have a jurisdictional rule that says you can't tax if all you do is sales in the State.

So I think these are things Congress needs to think about.

Mr. JORDAN. I have got 30 seconds. You are supportive of Congressman Johnson's. You are unsure of Mr. Boucher's. Where are you at on 1019 and 1521, Video Tax Fairness Act and the Cell Tax

Fairness Act? Where are you at on those two? We have got four bills kind of in front of the Committee——

Mr. HELLERSTEIN. Right, and I am—again, I have—you know, I may not have the numbers right, but I can tell you that I think that the bill involving the question as to whether or not New York should be able to employ its convenience of the employer rule—again, I think that would be—that would be appropriate for Congress to say, "Here is the general rule for allocating personal income from—among States, rather than having overlap."

I think, in my judgment—and I have said this in print—I think New York has overreached in that instance.

What was the other bill you mentioned?

Mr. JORDAN. Video Tax Fairness Act, Sales Tax—Cell Tax Fairness Act, 1521.

Mr. HELLERSTEIN. I don't think I am familiar with that—with that bill.

Mr. JORDAN. Okay. All right.

Thank you, Mr. Chairman.

Mr. COHEN. Thank you, Mr. Jordan.

Ms. Lofgren, the distinguished Chairman of the—and an expert in this subject, you are recognized.

Ms. LOFGREN. Well, I don't know if I am an expert on the subject, but I am the author of the Cell Tax Fairness Act.

And as I listen to—this is a complicated subject, really. I mean, it—in terms of business activity, taxing of employers, sales and use tax—I mean, it is not just a one-issue type of thing.

But the question I have, Mr. Johnson—and I am very sympathetic to State and local government, but I am also aware that we have some national priorities, which is why I introduced the Cell Tax Fairness Act.

We have taken a position as a Congress, and the President has taken the lead, that broadband deployment is important for the economic development of the United States, and it is more than just people being—it is a generator of additional economic activity.

We are behind other industrialized nations. And we are falling farther behind. In some cases, we are even behind countries that we wouldn't expect to be behind.

And if you take a look at how is access occurring to broadband, increasingly it is with cell phones. And that is especially true for low-income Americans and especially true for minorities.

If you take a look at who has access to broadband primarily through a cell phone, it is a younger person, it is a person with less income, it is an African American or Latino person, more than someone who has the bucks to go out and buy an expensive desktop.

I am struggling with, you know, what is the proper balance for the Congress. We have this priority, and yet State and local governments have increased the taxes on—and burden to access on the lowest income Americans on their broadband access at a rate twice as fast as the taxes on any other goods.

So do you think that that is an appropriate point of interest for us? And if not, why not?

Mr. JOHNSON. Well, let me—and thank you for the question. Let me respond in a couple of ways. First, let me acknowledge that the

Mobile Telecommunications Sourcing Act was a good example of a situation where the States and the businesses came together, said, "We need a solution here, let's go to Congress with something we can all agree on," and we all agreed on it, and Congress enacted it.

I am sure there are some businesses that didn't agree with it. I am sure there are some States that didn't agree with it. But there was a broad recognition that that was a problem that needed to be solved, and we did that cooperatively.

You know, I am sympathetic to the problems of the low-income households. And those are also the people that are primarily the recipients of a lot of the government aid and assistance. And if the infrastructure is not there, if the rapid transit systems aren't there, if those systems aren't available to the community——

Ms. LOFGREN. No, and that is why I am so——

Mr. JOHNSON [continuing]. We are going to have a problem.

Ms. LOFGREN [continuing]. Sympathetic. I mean, so many essential services are provided by State and local government, oftentimes with Federal assistance.

But certainly, the provider, on-the-ground provider, is often State and local government. And I mean, I spent almost as many years in that role in county government as I have in the Congress. So I am not hostile to that point of view.

Mr. JOHNSON. And the streamlined sales tax agreement—let me point out—we did not require each locality to give up its own rate, but we did require them—and the agreement does require them to give up the ability to set their own tax rate, to have their own—excuse me, their own tax base.

So those are difficult problems of balancing.

Ms. LOFGREN. If I can, I am going to go to Mr. Crosby, because, really, what the bill does—it doesn't repeal it; it just freezes it, and it also talks about differential rates, and I heard a muttered comment that it is always easy to tax somebody who is not a voter in your jurisdiction. You know, that is a preferred way.

And that is also a preferred way for people who do not turn out to vote in large numbers, so I think that is why the low-income users of this broadband access have been particularly victimized.

Mr. Crosby, I am very sympathetic to your concerns. However, business also needs what State and local governments provide, and especially education. If we don't have a great educated American public, we don't have a future as a country.

So how do we—if we do these controls, how do States and local governments make up for the revenue that they need to provide these essential services?

Mr. CROSBY. Thank you, Congresswoman Lofgren. That is a great question. I would say, first, turning to Professor Hellerstein, his encouragement to you that you look carefully at these issues is one that we would agree with as well.

Certainly, COST and the business community is not suggesting that you should eviscerate State and local tax bases. In many cases, that is not at all what we are talking about. In fact, all we are simply asking the Congress to do is to set the boundaries for when State tax jurisdiction ends.

It must end somewhere. Where is it? We don't know. The Constitution provides the due process clause. The Commerce Clause—that has not been well designed. I mean, in terms of—there has not been answers from this body or from the court as to where the limits are.

So I think that would—you know, the main response—the goal is not to eviscerate State and local revenues.

I also would like to note a study that our organization does every year shows that businesses in this country currently pay more than 45 percent of all State and local taxes. These bills would not meaningfully change that figure. Businesses would still be paying substantial amounts of State and local taxes across the country.

So I think it is really a question of the balance of what is the import of the national economy versus the needs of State and local government and striking that proper balance. And if you do that well, I think that the benefit accrues to all.

Ms. LOFGREN. Thank you.

I yield back, Mr. Chairman.

Mr. COHEN. Thank you, Ms. Lofgren.

I now recognize the distinguished Ranking Member, Mr. Franks.

Mr. FRANKS. Thank you, Mr. Chairman.

And Ms. Lofgren doesn't confuse me nearly as much as Mr. Watt.

Commissioner Johnson, you know, I suppose in an ideal world it would be great if the States—if we had some sort of magic nexus where the State that the business originated in, whether it was physical presence or economic presence, or whatever, had the tax base rights and then, of course, there would be competition among the States to keep their taxes low in order to attract those businesses. There would be sort of a natural regulation, as it were.

But you state that the physical presence nexus standard which the Supreme Court has held is necessary for sales and use taxes is antiquated. And the State and localities have also been opposed to a physical presence standard for business activity or franchise taxes.

So I guess my question is why should Congress support an economic nexus text over a physical presence test when the physical presence test gives businesses a certainty to do their tax planning? It is something that—you know, it is definable. So I know that is a fun question, but——

Mr. JOHNSON. Thank you, Congressman. I practiced State and local tax law at a private firm for 17 years before I became a member of the commission. The physical presence test in the context of the modern business world simply makes no sense.

There are under the current BATSA bill—there are so many ways to structure your operations around that bill to avoid taxation and still have exactly the same economic footprint in the State.

It is simply a roadmap to—I won't say abuse, because it is legal. If it is authorized by Congress, it is legal. But the same kinds of things we see in tax havens overseas we would be seeing in spades in local taxation. It doesn't make sense in today's economy.

Mr. FRANKS. Is there any overall principle—sometimes, you know, it is good to go back to some principle that even though it can't be applied in every circumstance—is there any kind of under-

girding guideline that you sort of refer to in your own mind as a better approach?

Mr. JOHNSON. Well, you know, the Multistate Tax Commission, for example, has proposed a uniform nexus standard for the States to adopt that would have reasonable force.

If you didn't exceed in that case $500,000 worth of sales, or $50,000 worth of payroll, or $50,000 worth of property in a State, you wouldn't be subject to the income tax. I proposed that legislation in Utah because I thought it made a lot of sense.

Small businesses particularly should have some certainty, and they should have some security, and there should be some thresholds that are recognized. And the States, frankly, need to do a better job. But I would encourage COST and the businesses to approach the States and say, "Look, this is a problem for us. Let's get it solved." And they can knock off some States.

Now, I know it is harder to knock off 50 States than it is, in many cases, to come to Congress. But that is our Constitution. You know, the States have sovereign rights. And I think the States will be receptive to those approaches, perhaps not this year. They might want to wait for a slightly better budget year.

But that is basic fairness. I don't want to get income tax returns from somebody that sells $15 worth of stuff in my State. That doesn't make sense for the taxpayers. It doesn't make sense for the tax collectors.

There are some minimum thresholds that the States should adopt, and we would be happy to work with the business community in trying to implement those on a State-by-State basis.

Mr. FRANKS. Thank you, sir.

Professor Hellerstein, you don't reference the 10th Amendment in your testimony, so I guess to what extent, if any, should the 10th Amendment constrain Congress' authority to legislate in this whole area we are discussing here?

Mr. HELLERSTEIN. Well, from a constitutional standpoint—that is, from a legal standpoint—not at all.

I mean, I think there is virtually no doubt that Congress has ample power, as the U.S. Supreme Court has said—the 10th Amendment, to exercise its power under the Commerce Clause to create uniform rules for State taxation, to create thresholds, even, in fact, to create bases.

There once was a time when it was thought that the 10th Amendment was a constraint on Congress, and there was a case called National League of Cities back in 1976. That case was overruled. So I think the short answer is the 10th Amendment does not, as a legal matter, constrain what this body can do.

It may well be that if one is a fan of the 10th Amendment one thinks Congress shouldn't do something. But there is no legal constraint on Congress that the 10th Amendment in this context, I think, imposes.

Mr. FRANKS. Mr. Chairman, could Mr. Johnson have a shot at the same question?

Mr. COHEN. You are recognized, Mr. Commissioner.

Mr. JOHNSON. Thank you, Your Honor. Excuse me.

Mr. COHEN. You are competing with Mr. Crosby now for witness of the day.

Mr. JOHNSON. Oh, thank you, Your Honor.

[Laughter.]

The Congress, I think, does have plenary authority in the Commerce Clause area. The 10th Amendment is still very much alive in very many areas. And I think the intent of the 10th Amendment clearly has to, you know, inform what Congress chooses to do in exercising its Commerce Clause power.

Mr. COHEN. Thank you.

Before I recognize Mr. Johnson and continue this sexy subject that this Committee often gets into, I would like to pause for one question for Commissioner Johnson and Mr. Johnson only.

What do you think of the BCS?

Mr. JOHNSON. We are not fans of it in my part of the country.

Mr. COHEN. I didn't think so.

Mr. Johnson, you are recognized.

Mr. JOHNSON OF GEORGIA. Thank you, Mr. Chairman, for holding this hearing.

And before I get started, I did want to announce my own personal choice for witness of the day, and that honor should go to my good friend from Georgia, Professor Hellerstein.

Mr. HELLERSTEIN. Thank you, Congressman.

Mr. JOHNSON OF GEORGIA. Yes, sir.

Mr. COHEN. You realize he has no jurisdiction to put any honor on you, sir.

Mr. HELLERSTEIN. He has jurisdiction over my children.

[Laughter.]

Mr. JOHNSON OF GEORGIA. There you go.

I do want to talk a little bit about H.R. 2110, the mobile workforce bill that would clarify and make uniform the laws with respect to employee withholding taxes and a duty on employers to withhold those taxes.

And what kind of problems do we get when we have so many different tax rules coming out of 50 States? How does that affect our ability to compete? How does that affect efficiencies with respect to both sides of the issue, States and employers and employees?

And I also would like to take the opportunity, before I expect an answer, Mr. Crosby, to say that this is a issue that has been percolating long before Hank Johnson arrived in Congress.

And a previous congressperson from Utah was a big proponent of this, as you well know, Mr. Johnson.

So, Mr. Crosby, if you would take a stab at that.

Mr. CROSBY. Thank you, Congressman Johnson. We appreciate your leadership on this issue and Congressman Franks and Congressman Jordan also for their leadership on this issue.

The problem of traveling employees and their taxation is a very interesting one. It is one of those classic examples where the greater someone tries to comply, the greater the burden becomes.

If you travel for business around the country and are unaware of the laws, or choose to ignore the laws, your burden is likely relatively light.

But if you actually try to comply with the laws of this country, you could have a substantial burden to pay income taxes and to file tax returns in the States where your presence is fleeting at best.

And from a financial perspective, for your taxes, in most cases you will not end up worse off, because in your home State you are going to get a credit against those taxes, but administratively the financial burden of filing all those forms can be quite considerable.

I myself have looked into this. I travel fairly widely around the country. I live in the State of Maine that has an 8.5 percent personal income tax rate. And so for almost every place I travel, were I to file in all those places, I would receive a credit on my Maine state return.

But in 2008 I would have had to file returns in nearly 20 other States. That would have been an enormous burden. And I am willing to admit that I did not do that, because I could not do that.

For the employer, the burden is equally great. The employer has to track their employees' whereabouts, and for most traveling employees there is nothing that ties back into the payroll system that says where the employee is.

Their boss may know, but the fact is most traveling employees don't fill out time sheets, don't keep track of their time on a daily basis. They do their jobs as they are instructed to do them.

And so for the payroll systems to have to try to split pay periods, and withhold part to one State and part to another State, and keep track of all these things is enormously complex and expensive.

And so again, here, the companies that try to comply with these withholding requirements are the ones that bear the greatest burdens.

And in the current environment, the changes that now has—that have come from Congress and other places over the past decade, companies are increasingly concerned about complying with all laws and regulations regardless of whether a tax authority is auditing them.

So this is an increasingly important issue for businesses and employees. And as more companies put in place systems to comply, more employees are forced to deal with these laws.

Mr. JOHNSON OF GEORGIA. Thank you, Mr. Crosby. I would like to have a response from Mr. Johnson to this question. The mobile workforce bill, H.R. 2110, would set a 30-day uniform threshold across the Nation. Why is this 30-day threshold preferable to a shorter period as many have—or as some have suggested?

Mr. JOHNSON. Thank you, Congressman Johnson. Why is it preferable to a shorter period? I think States—as far as I know the FTA is comfortable with a 30-day period.

A shorter period would be even more burdensome on the businesses because then if they had, you know, a 2-day threshold they would have to file in lots of places. So I think the 30-day period is reasonable.

The FTA, as you know—I hope you know—has been working closely on many provisions of this bill. We certainly recognize there is a problem. There is also a uniform law project under way at the Multistate Tax Commission to address this problem.

It is a problem. We recognize it. And we want to work with the business community in solving it.

Mr. JOHNSON OF GEORGIA. Thank you.

And if I could, Mr. Chairman, just one—if I could get a comment on that same issue from Professor Hellerstein.

Mr. HELLERSTEIN. Yes. Thank you, Congressman. Well, again, as I testified a couple of years ago, I believe this is a perfect type of intervention by Congress. We need a uniform rule. We have heard about the burdens that this creates.

You know, precisely what the line is—again, that is not my area of expertise. But I would say this is exactly, I think, what Congress should be looking at, looking at administrative burdens, I would say, in other areas, too, and making sure that in this context, where, as Mr. Crosby has pointed out, there is really not a huge amount of revenue at stake, and it is really a question of which State gets the income, and if—it is not going to make a large bit of difference.

This is, I think, a place where Congress can do a lot of good without doing a lot of harm in terms of intrusion into State sovereignty, because the States are not going to voluntarily get together and choose the right or a particular rule. That I think we have learned. States are not very good at doing that.

Mr. JOHNSON OF GEORGIA. Thank you, Mr. Chairman—witnesses.

Mr. JOHNSON. Mr. Chair, I apologize. I need to amend my testimony. As I am looking at my notes, if I may, the 30-day period—I think the problem that we have with 30 days is that, you know, 30 working days is closer to 6 weeks, and I think we are—we do have a problem with that.

Mr. COHEN. In the Senate, it is about 3 years.

[Laughter.]

Mr. JOHNSON. We would like a shorter period than that. Like I say, working days—that is 6 weeks. If you are going to be in a State, you know, for a month, you are working 20 days. Certainly, that, I think, is not an unreasonable burden to put on an employer.

The other concern we have, of course, is the limitation on the taxation. We recognize that there are good reasons—problems with withholding, but at the end of the year, you know where you have been. There is no uncertainty. And you can figure out what the taxes are and get appropriate credits.

So I apologize for my misstatement on that.

Mr. COHEN. Thank you. You are now second place, a half a remark behind Professor Hellerstein and Mr. Crosby.

Mr. Coble, you are recognized.

Mr. COBLE. Thank you, Mr. Cohen—thank you, Mr. Chairman.

It is good to have you all with us today. Gentlemen, it is essential for our economic well-being and only fair to businesses or taxpayers that they have certainty in knowing where they may or must pay their taxes.

In reading the prepared remarks submitted for the record, particularly of the American Truckers Association, U.S. Bancorp and the Consumer Electronics Association, it appears clear to me that we have an unpredictable, chaotic and sometimes unfair system of State tax collection. And I will be glad if you all concur or disavow that subsequently.

But H.R. 1521 prohibits local governments from imposing new discriminatory taxes on mobile services for 5 years. Now, I understand that many taxing regimes for mobile services are unpredictable.

But, gentlemen—and I will start with you, Mr. Johnson—why has this occurred to the mobile industry as opposed to other local industries?

Mr. JOHNSON. I am sorry, Mr. Coble, could you repeat that question?

Mr. COBLE. H.R. 1521 prohibits local governments from imposing new discriminatory taxes on mobile services for 5 years. Why is this applied only to the mobile services, as opposed to other local industries? I think you may have touched on that earlier.

Mr. JOHNSON. Well, we are certainly not—we are not supporters of this bill. We do think it singles out a particular industry for special treatment.

We would also note that this is a dynamically changing industry. Any kind of a preemption, particularly for 5 years, seems to us to be unreasonable. Discriminatory is also in the eye of the beholder. If this discriminates against interstate commerce in a constitutional way, the State law wouldn't be upheld.

So what we are talking about here is preventing a locality from distributing its tax base the way it thinks appropriate. And all taxes in one sense are discriminatory. Some things are in the tax base. Some things are not.

You know, some income earners get a different rate than other income earners on income taxes. That is discrimination, I think, within the sense of this bill, but it may be very, very good tax policy. So we would oppose that bill.

Mr. COBLE. Thank you, sir.

Mr. Crosby, do you want to weigh in on that?

Mr. CROSBY. Thank you, Congressman Coble. I will preface my statement by noting that as an organization that broadly represents business, we tend not to become involved with taxes on individual business segments.

That said, however, COST has long studied the impact of taxes on telecommunications around the country, sort of adding them up and determining what burden is imposed on telecommunications.

And Mr. Johnson indicated that the legislation singles out one industry. I would note that I think that the reason that the bill is before the Congress is because that industry has been singled out for extra attention when it comes to tax matters as well.

And so, you know, certainly, it is the case that over our history State and local governments have imposed greater tax burdens on regulated utilities and they have, as the cellular telecommunications industry has grown, begun to export those tax burdens to wireless telecommunications as well.

Mr. COBLE. Thank you, sir.

Professor, do you want to insert your oars into these waters?

Mr. HELLERSTEIN. All I would say is, you know, you have to be very, very careful, I think, in legislating for specific industries, at least without very strong evidence that that particular industry needs the protection.

There is the "me, too" problem, as you have probably seen. Once one industry says, "Gee, we are having this problem," then there are always the economists that can bring you the data that show that they are being discriminated against.

So I think it is certainly an area where I think intrusion into State prerogatives as choosing their tax base is quite sensitive.

Now, there may well be instances in which the proof is overwhelming that a particular industry has been singled out, looking at all taxes, and if the evidence is overwhelming it may be appropriate for Congress to act.

But I think Congress has to look very, very carefully at the facts before, in effect, saying that States may not tax this or that or the other, because there is a tendency, I think, once one industry gets a particular benefit—"Why not me? I want that same benefit."

Mr. COBLE. Thank you, gentlemen.

I yield back, Mr. Chairman.

Mr. COHEN. Thank you, Mr. Coble.

Mr. Scott, the Chairman of the Criminal Law Subcommittee and gentleman from Virginia, you are recognized.

Mr. SCOTT. Thank you. Thank you, Mr. Chairman.

Mr. Chairman, I got involved in this issue when a local food processor brought it to my attention that one of their trucks traveling through the State of New Jersey had essentially been hijacked and held hostage until they had wired the State of New Jersey some money to release the truck.

They had no sales force, nobody in New Jersey, just driving through, and essentially got hijacked. And that obviously isn't fair, but as the gentlelady from California mentioned, it is great taxation policy where you can whack people that are out of State and can't vote for you.

Just from a practical point of view, Mr. Crosby, can you talk about the problems in trying to figure out what sales tax you might owe as you go through cities, States, counties, in terms of whether something is food or not food, or exempt for food, or whether it is a Labor Day holiday or whatever?

Can you talk about the problems in calculating what tax you might owe if it is a sales tax?

Mr. CROSBY. Thank you, Congressman Johnson—or, excuse me, Congressman Scott. With regard to sales and use taxes, the difficulty for retailers who sell into a national marketplace and who may not be physically located in a jurisdiction is the fact that there are more than 6,000 sales and use tax jurisdictions around this country—different bases, different tax rates, different definitions of items that may be identical across the country but defined differently across the country.

And I think that is why, as Mr. Johnson talked about in his testimony and I briefly touched on in mine, the Council on State Taxation, the Federation of Tax Administrators and many other business and State groups have come together to try to address these issues through the streamlined sales tax project.

So when it comes to sales taxes, we have been working on it 10 years. We have made progress. We are not at the end of the game. But it is certainly something that Congress needs to——

Mr. SCOTT. What about business tax—business taxes? Do they differ from jurisdiction to jurisdiction——

Mr. CROSBY. Yes.

Mr. SCOTT [continuing]. And cause the——

Mr. CROSBY. Yes, sir.

Mr. SCOTT [continuing]. And cause the same kind of complication?

Mr. CROSBY. Business activity taxes are—it is a little different of an issue. Because of the sales tax arena, the tax is actually owed by the person who lives there.

With regard to business activity taxes, it is unclear to businesses exactly what activities are going to trigger a tax liability in a jurisdiction, whether it be the State or local governments.

And your example about the Virginia food processor who was just transiting goods through the State of New Jersey and had their truck stopped and had to wire money before they were able to get the truck released is not a singular example.

These sorts of things have happened in many other businesses, small businesses and large businesses alike. One of the major problems is that the businesses are filing their returns under their understanding of what the law is today. That is unclear.

Years later, tax administrators may come back and say, "You failed to collect or you failed to remit taxes we think you ought to have had to remit and you are required to file returns and contest them in court or capitulate and pay taxes you don't think you owe to avoid the costs of litigation."

Mr. SCOTT. Well, you mention years later. You have confessed to possible transgressions. Is there——

Mr. CROSBY. Yes.

Mr. SCOTT. Is there any statute of limitations?

Mr. CROSBY. I am comfortable in that area because my home State of Maine taxes at a relatively high rate that I could file amended returns and receive the credits and——

Mr. SCOTT. Well, there is a—there is certainly a limit on how far back you can go. Is there any statute of limitations on what they—when they can go back and charge you?

Mr. CROSBY. Not if you haven't filed a return, no. And that is one of the problems——

Mr. SCOTT. So you can go back decades.

Mr. CROSBY. They can go back—yes, decades, indeed.

Mr. SCOTT. Okay.

Mr. Hellerstein, you mentioned a situation where if you go to Oregon and buy a car without paying a sales tax because they have no sales tax and bring it back into a State with a sales tax you pay the sales tax or use tax there.

What if you buy it from a State that has a sales tax, you pay the sales tax there, do you still have to pay the use tax when you get back home?

Mr. HELLERSTEIN. No, you get a credit against the sales tax that you paid where you purchased it in the State where you bring it back.

So if instead of going to Oregon you had gone to California and paid a sales tax and you brought it back to Washington and went to register it, assuming the sales taxes were the same, you would pay no use tax.

Mr. SCOTT. Well, are all States—do all States give credit for taxes paid to other States?

Mr. HELLERSTEIN. Yes. As a matter of constitutional law, they have to.

Mr. SCOTT. In terms of income tax on telecommuting, you could have a situation where someone lives in northern Virginia, works at a place located in Maryland, and never set foot in Maryland because you telecommute, or you telecommute once a week, or you take home—take work home with you at night.

How would you ever calculate who—what income tax you owe to which State?

Mr. HELLERSTEIN. Well, again, it would depend on the State rules. If a State had a rule that said—that determined how much a non-resident—we are talking about a non-resident, because State residents—will tax you on all your income.

If it is on a physical presence, daily count, it is pretty easy. If it isn't, if it is a rule such as the rule that New York has, which says, "Well, we are not going to count days that you are not in New York if it was not for the convenience of the employer," if the employer didn't say, "You must be in a particular location," it becomes more difficult.

Mr. SCOTT. If you do show up—I think for sports players, when they go to play a game, they show up for 1 day. The State where they are playing wants to tax them. Do they count the practice and all that that went into it, or they count the number of games divided up? How do they calculate it?

Mr. HELLERSTEIN. That is a very good question. In fact, there are—the question as to how athletes and professional sports teams should calculate their income in various States—should it be on a games-played basis? Should it be on a physical presence during the—during the off season?

And in fact, the Federation of Tax Administrators has a uniform statute that they have urge States to adopt to deal with sports, because that is a very special problem, and there are various approaches to this. I think there is a good uniform approach that the Federation of Tax Administrators has recommended.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. COHEN. Thank you, Mr. Scott.

The bells indicate we have votes in 15 minutes, so we are kind of in overtime, and I am going to ask Mr. King and Ms. Chu, who have been good enough to be here, to limit their answers and questions to 4 minutes and ask the respondents to answer quickly.

Mr. KING. Reserving my right to object, Mr. Chairman, I would point out that nearly everyone on this panel ran over the 5 minutes, and so I had some important things that I want to raise, and I will try to respect the time, but—and I will just make this point, because I sit here and listen to this go back and forth and back and forth, and there will never be an end to the discussion and the argument, because where you sit is where you stand.

So you will always try to draw a little advantage for—whether it is for Maine, or Utah, or whatever it might be, because you see it through that lens.

And there is a certain characteristic of human nature that I have noticed in my times of business and public life, and that is that if you appoint a committee, that is the first thing that sets the conclusion that the committee will draw.

The second thing is you assign a charge to that committee, a mission, and they will start down that path, limited within the definition of that mission.

Then you appoint or elect a chair, and that chair will then have an agenda. And if it is a powerful chair, and usually it is, the members on the committee will line up behind the agenda of the chair, and then they will just seek to perfect that path or that track that has been laid out by the committee, the appointment to the committee, the mission for the committee, and by the chair of the committee.

And so as I listen to this, it occurs to me that we have been dealing with something here, the—well, the Federal income tax and the State income tax—that next year we will celebrate the 150th year of the first income tax in America. That was by the Confederate States of America in 1861—lasted 10 years.

Then in 1894 we had a Federal income tax that lasted for a year. It was determined to be unconstitutional. And then the Congress just last—100 years ago last year passed the constitutional amendment, the 16th Amendment, and it took a few more years, 4 years, to ratify that.

So soon we will have a century of the income tax. And I am hearing that what we have is archaic, physical presence is archaic because the world has moved on, yet we are cobbling together how it is we are going to bolt new parts onto a more-than-centuries-old income tax system that was Federal and most of the States have adopted on, and each one has a different set of rules.

So I am going to submit that this Committee has gotten more and more tunnel vision over the years. And we have not stepped back and looked at this from 10,000 feet.

And we haven't decided how we are going to adapt a tax policy for the United States of America that is right for the 21st century and maybe lays the groundwork for adaptation into the 22nd century.

And I am going to say for the 21st century the IRS itself has to go. It is a cobbled mess that no one understands. And it creates the convolution of the States' income taxes as well.

And setting aside the Federal problems that we have, even if we do the things that have been advocated here by each of you in certain ways, and Mr. Johnson most recently, we are still going to end up with 50 different models, as clean as it might be, to go see what the State's policy is.

I am going to suggest why don't we do one model for the United States of America? Why don't we allow the States within the 10th Amendment to conform in a fashion that will allow us to have an opportunity for a single model that would be conducive to business in all the States and completely simplify this?

The streamlined sales tax, which I have done some work on as a State legislator—and I am not quite to the point of despair, but it is very difficult to get to the point to get enough States to agree.

I believe if we go to a national sales tax the States will follow, probably all of them eventually. And the streamlined sales tax can be a tax—a low tax on all sales and service, regardless—we don't have to have the discussion about what is taxed and what is not—everything, last stop retail, sales and service.

If we do that, we eliminate everybody's problem here. We can solve the Federal problem with this convoluted mess.

Another point that I would make—and it would be in disagreement with Mr. Crosby's statement that businesses would still be paying taxes—I have never believed that businesses pay taxes. They pass them along to their customers. Taxes are really assessed at the retail level, sales and service.

And so this simplification that I am proposing solves every problem here, and it creates a dynamic economy, States and in the Federal Government, and it moves us into the 21st century in a way that we have got a model to work on rather than this model that has had parts bolted on it and been upgraded and convoluted for 150 years.

And if there is anybody on the panel that would like to tell me how much you have thought about that, that I have just described here today, and speak to that, I would be very interested in hearing it.

Mr. Johnson?

Mr. JOHNSON. I think at the FTA we believe that the State sovereignty is core. The ability to raise your revenues and determine how those tax revenues are shared by the people of the State is an important part of the legislative process. And we think that is what the Constitution envisioned. It is not pretty.

Mr. KING. Mr. Johnson, I agree with you in the 10th Amendment principles. I am going to suggest the States would opt in if the Federal Government would go to a national sales tax, because they would see how it is streamlined in that fashion.

At this point, I think I would just conclude. And I appreciate the witnesses' testimony.

And I would yield back the balance of my time.

Mr. COHEN. Thank you, sir.

Ms. Chu? Thank you. You are recognized.

Ms. CHU. Well, I know we are under time pressure, so I would be happy with a very succinct answer. But I am really happy to see Congress step in and to—for us to be pursuing this line of reasoning because of my previous position.

Prior to this, I was elected to the California State Board of Equalization which collected the sales tax for the State. And overall, we collected $53 billion worth for the State of California.

And we watched as there was a decline in sales tax revenue as there were more sales online and the bricks and mortar companies were suffering, which forced California to rely more on income tax for its State revenue rather than sales tax, which resulted in a much more volatile revenue stream for the State of California.

And so we have this—these hodgepodge of laws, and the latest example is Expedia, which negotiated rates with hotels, of course charging a—ultimately charging a lower wholesale room rate than what an individual could get on their own, and—but then only paying local taxes on the wholesale rate rather than the rate that they charged customers.

And the city of Columbus, Georgia, sued Expedia for this practice, saying that the city had a right to the—that which was charged the customer. Well, Expedia argued that they didn't have to because they didn't have a physical presence.

But it went to the Georgia Supreme Court and the supreme court decided that Expedia did have to pay the—have to pay the higher rate, the rate that they were charging the customers.

And recently, there was a case in California where a California city is suing Expedia for—also for the hotel tax that they charge every hotel in the city.

So my question is why should there be a standard definition across the States? What is the fairest way to create these standards? And on the nexus issue, should there be separate legislation for each situation, sales tax versus income tax?

Mr. HELLERSTEIN. Is that——

Ms. CHU. For anybody, yeah.

Mr. HELLERSTEIN. Well, I mean, there are a lot of questions there. I think, first of all, it is my view, as I stated in my testimony, that I think that certainly with regard to sales tax, which is probably the biggest issue than the one you address, I believe very strongly that Congress needs to take a very hard look at whether the physical presence standard really makes any sense.

I mean, is that a good proxy for an ability to comply with the sales tax? And if it doesn't, there may well be another standard, and another standard that is really much simpler.

Anybody that says the physical presence is clear has not read hundreds of pages of my treatise, hundreds of pages of case after case after case which has a different definition of what constitutes a sufficient physical presence to create nexus.

A simple rule that said 10,000, 100,000, a million—you pick the figure—I think would be certainly simpler. And that is a—that is a question Congress needs to ask.

I think the Expedia question is another very important question but, unfortunately, for the moment, one very much mired in local accommodations taxes. I would agree with you that it would be nice to have a uniform rule that taxed on a uniform basis if the States decide to tax.

Right now, the problem really is that these are not system-wide taxes. They are local accommodations taxes. And the real question is whether under one of those taxes the—is Expedia an innkeeper, and so it is a technical problem. Congress might well want to intervene in that area.

But again, it would clean up a lot of the sub-national and sub—even below the State level—clean up a lot of the uncertainty. But again, there is the question of how far does the Congress want to intrude into what has historically been clearly a matter for local determination.

Ms. CHU. Thank you.

Mr. COHEN. Thank you, Ms. Chu. I appreciate it.

And I thank all the witnesses for their testimony today. It is a tie for witness of the day. We had three great witnesses.

Without objection, the Members will have 5 legislative days to submit any additional questions which we would forward to the witnesses and ask you answer as promptly as you can. They will be part of the record.

Without objection, the record will remain open for 5 legislative days for the submission of any other additional materials from Members of the Committee or from witnesses, I guess.

Again, I thank everyone for their time and patience. This hearing of the Subcommittee is adjourned.

[Whereupon, at 1:05 p.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

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

Each Congress, this Committee considers several legislative proposals which seek to restrict or expand the ability of States to tax income or transactions.

One such proposal includes Congress' granting authority to States to require remote sellers to collect and remit sales taxes.

Another proposal seeks to establish a set standard for taxing certain business activities.

Yet another proposal, one which I introduced, focuses on the discriminatory tax treatment by States between cable and satellite television providers. Several of these legislative proposals touch upon the complicated issue of "nexus." Because of its complexity, and it being the basis for when a State can rightfully impose a tax, a discussion on "nexus" merits its own hearing.

I welcome today's hearing, and find it timely in light of the current economic situation.

As we hear testimony from today's witnesses, we should consider the following three points:

First, to lift this country out of the current economic doldrums, we should provide certainty to encourage the free flow of commerce.

We need more businesses to produce goods and provide services to help create much-needed jobs. These jobs help workers get back on their feet, and create a market for more goods and services. To encourage this economic revival, businesses, and taxpayers in general, need certainty to operate. They need simple and clear tax structures to know what activities will trigger tax liability in a State.

The certainty of knowing when tax liability is triggered will help businesses to plan for investments, and to know when to withhold an employee's income tax, or collect and remit a sales tax.

We should urge the creation of State and local tax policies which are clear, fair, and certain. Such policies would not hinder the free flow of commerce, but would encourage technological development, efficiencies, and job creation.

Second, our State and local governments are currently hemorrhaging during this continuing economic downturn. Although the fourth quarter GDP points to an economic turnaround on the horizon, State and local revenues are still declining for the foreseeable future. My home State of Michigan has been especially hit hard, as its tax base dwindles after employers lay off workers, home prices fall, and consumer spending drops.

For that reason, we should examine carefully any legislative proposal that could further depress State and local revenues and those governments' abilities to provide their residents essential services.

Congress should tread lightly when considering legislation that may force State and local governments to decide whether to cut spending on law enforcement, or much-needed repairs to infrastructure or education.

Whenever States are forced to lay off teachers, eliminate after-school programs, or raise tuition at State universities, the future of the next generation, and in turn, our country, is negatively impacted.

Congress should take seriously the plight of State and local governments. In fact, this Subcommittee should hold a hearing on what Congress can do to help State and local governments weather the current downturn.

Third, when we review legislation concerning State taxation, I have encouraged State and local governments and the relevant taxpayers to work reasonably together to create tax policies that are clear and competitively neutral, and that do not un-

necessarily limit State and local revenues and authority. Although Congress can legislate solutions to nexus issues, the interested parties may be able to find better solutions amongst themselves. If Congress later chooses to provide solutions, the testimony from today's hearing will be invaluable to help us develop fair and straightforward legislation.

I thank Chairman Cohen for holding this very important hearing, and I look forward to hearing today from our three distinguished witnesses.

RESPONSE TO POST-HEARING QUESTIONS FROM WALTER HELLERSTEIN, FRANCIS SHACKELFORD DISTINGUISHED PROFESSOR IN TAXATION LAW, UNIVERSITY OF GEORGIA SCHOOL OF LAW

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Role of Congress in Defining Nexus
February 4, 2010

Walter Hellerstein, Francis Shackelford Distinguished Professor in Taxation Law, University of Georgia School of Law

Questions from the Honorable Steve Cohen, Chairman

1. In your written testimony you note that "establishing that nexus means 'minimum required constitutional connection' and that the requirement exists in a variety of contexts does not tell us much about what nexus means as a practical matter in these contexts." Given that the principal concern of the Commerce Clause is national economic unity and the effects of state regulation on the national economy, do you think that a standard of "economic nexus" or "significant economic presence" is a more appropriate standard than a physical-presence test to determine the meaning of "substantial nexus"? Does such a standard satisfy the due process inquiry?

As I suggested in my written testimony, I believe that there are contexts in which "economic nexus" or "significant economic presence" are indeed a more appropriate standard than physical presence to determine the meaning of "substantial nexus." Take, for example, the question of the appropriate standard for requiring an out-of-state vendor to collect a use tax on sales of goods in a state. We can all agree that requiring a remote seller to comply with a use tax collection obligation may well impose a burden on interstate commerce if the compliance burdens are unreasonable.[1] The question, however, is whether physical presence is a good proxy for determining whether such burdens exist. In my view, a small business that has an insubstantial volume of sales in a state to which it sends an occasional salesperson (thus establishing a physical presence and triggering a tax collection obligation there) is not better equipped to comply with that state's tax laws than a large Internet retailer, which has no physical presence in the state, but makes millions of dollars of sales into a state and employs sophisticated order fulfillment software that permits it easily to track its customers by zip code. Accordingly, I believe that a use tax collection obligation based on a threshold of sales into the state – "economic nexus" or "significant economic presence," if you will – is more appropriate than a rule based on physical presence. I would also observe that such a "distance selling" rule applies to the Value Added Tax (VAT) employed by the 27 Member States of the European Union, where vendors whose sales into a Member State exceed a specified euro threshold are required to register for VAT and to charge the destination state's VAT on its sales.[2]

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[1] In considering the burdens on the out-of-state vendor of complying with a state's use tax collection obligations, one should take account not only of the state use tax, but also any local use taxes that may be imposed by taxing jurisdictions within the state. The burden on the out-of-state vendor of complying with a state's use tax collection requirements, particularly in states whose localities may impose sales and use taxes whose bases vary from the sales and use tax imposed at the state level, can be heavy.

[2] *Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax* art. 34(O.J. L. 347, 11.12.2006, p. 1) (as amended); European Commission, Taxation and Customs Union, "Distance selling of

There is no substantial due process objection to a standard of "economic nexus" or "significant economic presence." As I stated in my written testimony, the U.S. Supreme Court has held that physical presence is not an essential element of due process nexus and all that is required is that a foreign corporation purposefully avail itself of the benefits of an economic market in the state. The "economic nexus" or "significant economic presence" tests would ordinarily satisfy the "purposeful availment" standard.

2. You note in your written testimony that apart from those few areas in which Congress has addressed state tax nexus issues, the delineation of the standards that in fact limit the states' power to tax has fallen entirely to the courts through their interpretation of the Due Process and Commerce Clauses. Do you think Congress should do more to delineate those standards? Why?

As I indicated in my written testimony, I believe that there are contexts in which Congress should do more to delineate state tax nexus standards. The reason for this is that there are a number of contexts in which the judicially developed standards do not give sufficient or appropriate guidance for taxpayers and tax administrations and the states do not appear capable of coming up with appropriate standards by themselves.

Once such context is a multistate company's obligation to withhold income taxes with respect to non-resident employees who spend limited amounts of time in a state. As I stated in previous testimony before this Subcommittee, *Testimony of Walter Hellerstein on the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007* (H.R. 3359) before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary (November 1, 2007), enactment of the proposed legislation "would constitute an appropriate exercise of congressional power." *Id.* at 9. In expressing that opinion, I also made it clear that "the states have a legitimate interest in assuring that workers who earn income in the state pay their fair share of the state tax burden for the benefits and protections that the state provides to them." *Id.* I further noted, however, that "[t]he states' legitimate interest … must be balanced against the burdens that are imposed on multistate enterprises, and on the conduct of interstate commerce, by uncertain, inconsistent, and unreasonable withholding obligations imposed by the states." *Id.* I concluded that "a targeted response" of the type reflected in the proposed legislation was warranted. My views are reinforced by an article on this very problem in the *New York Times* of March 21, 2010. See Catherine Rampell, "States Look Beyond Borders to Collect Owed Taxes," N.Y. Times, March 21, 2010, p. 1.

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goods," available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/distance_selling/index_en.htm; European Commission, Taxation and Customs Union, "Mail order and distance purchasing," available at http://ec.europa.eu/taxation_customs/taxation/vat/consumers/mail_order_distance/index_en.htm.

3. In your written testimony, you note that "there should be no serious debate over Congress's broad authority to adopt or consent to virtually any rule that it believes is appropriate in this domain." Why do you feel there should be no serious debate?

I feel that there should be no serious debate over this issue because the law, as summarized in my written testimony (and in my previous testimony before this Subcommittee, cited above), leaves no room for serious doubt over the scope of congressional power in this area.

4. You note in your written testimony that the Supreme Court's more recent decisions construing Congress's affirmative power under the Commerce Clause have taken a narrower view of that power. Why do U.S. v. Morrison and U.S. v. Lopez not inhibit the exclusive power that Congress possesses to address the problems raised by state tax nexus rules?

In *United States v. Morrison*, 529 U.S. 598 (2000), the Court held that Congress lacks the power under the Commerce Clause to provide a civil remedy for victims of gender-motivated violence because gender-motivated crimes do not substantially affect interstate commerce. Likewise, in *United States v. Lopez*, 514 U.S. 549 (1995), the Court held that Congress lacks the power under the Commerce Clause to prohibit possession of firearms in school zones because possession of a gun in a local school zone does not substantially affect interstate commerce. These decisions do not meaningfully inhibit the power that Congress possesses to address the problems raised by state tax nexus, because these decisions rested on the ground that the activities being regulated – gender-motivated crimes and keeping firearms out of school zones – did not substantially affect interstate commerce. In fact, the Court in *Lopez* reaffirmed, rather than discredited, the essential contours of the Court's affirmative Commerce Clause doctrine that supports congressional legislation addressed to state tax nexus. Thus, after summarizing the "era of Commerce Clause jurisprudence that greatly expanded the previous defined authority of Congress under that Clause," *Lopez*, 514 U.S. at 556, the Court identified "three broad categories of activity that Congress may regulate under its commerce power" (*id*):

> First, Congress may regulate the use of the channels of interstate commerce. . . . Second, Congress is empowered to regulate and protect the instrumentalities of interstate commerce, or persons or things in interstate commerce, even though the threat may come only from intrastate activities. . . . Finally, Congress' commerce authority includes the power to regulate those activities having a substantial relation to interstate commerce, . . . *i.e.*, those activities that substantially affect interstate commerce.

Id. at 567. Congressional legislation addressed to state tax nexus issues falls comfortably within the third category of those activities over which Congress may exercise its Commerce Clause authority. *See generally* Walter Hellerstein, "Federal Constitutional Limitations on Congressional Power to Legislate Regarding State Taxation of Electronic Commerce," 53 *National Tax Journal* 1307 (2000).

5. You have devoted most of your professional life to the study and practice of state taxation. So this area is your expertise. In your opinion, looking at this from a policy perspective, what should Congress do regarding state tax nexus rules? What is the fairest rule? The simplist [*sic*] rule?

As I said in my written testimony, I believe Congress needs to examine the nexus issues that arise in particular contexts and, should it conclude that the existing rules are unreasonably burdensome or unreasonably restrictive, adopt a rule that is most appropriate for the particular context. The criteria for determining what rule is appropriate will require a delicate balancing of administrative and revenue concerns that will respect both the legitimate interests of the states in revenue collection and the legitimate interests of the nation in assuring that interstate commerce not be unduly burdened by unreasonable tax compliance obligations.

There is no simple answer to the question "What is the fairest" rule. As a general proposition, it is the rule that best balances the competing interests concerned. As I have suggested above, two examples of rules that may be fairer than those now in force would be a sales dollar threshold for tax collection nexus and a working day threshold for non-resident income tax withholding nexus.

The simplest rule would be a rule that everyone can understand and that everyone can easily comply with. The simplest rule, however, is often not the fairest rule.

6. During the hearing, Commissioner Bruce Johnson discussed a uniform nexus standard devised by the Multistate Tax Commission. Please provide your thoughts on the standard as to whether it is a fairer method to determine state tax nexus than what is currently utilized. If you have an alternative, please discuss.

The Multistate Tax Commission's uniform nexus standard for business activity taxes, under which substantial nexus is established if the taxpayer has more than $50,000 of property or payroll or $500,000 of sales in the state, or more than 25 percent of its property, payroll, or sales in the state[3] – will in many instances be a fairer method to determine state tax nexus for income and other business activity taxes than what is currently utilized. Under existing nexus standards, a single employee or a single item of low-valued equipment in a state could trigger an income tax reporting and compliance obligation, even though the costs of compliance might well exceed the revenues at stake. By the same token, a taxpayer with millions of dollars of sales into a state, generating substantial income from in-state sources, is in many instances not required to pay income tax because of Public Law 86-272. It therefore may well be more appropriate to determine the existence of state tax nexus by reference to substantial amounts of income-generating factors in the state (property, payroll, and sales) rather than by reference to physical presence (however limited), which sometimes will result in too expansive a nexus standard and sometimes result in too narrow a nexus standard. *See generally* Charles E. McLure, Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of

[3] Multistate Tax Commission. Factor Presence Nexus Standard for Business Activity Taxes (approved Oct. 17, 2002), available at www.mtc.gov.

Three Proposals," *Tax Notes*, March 15, 2004, p. 1375 (also published in *State Tax Notes*, March 1, 2004, p. 721).

7. During the hearing, Rep. Scott asked you: "do all states give credit for taxes paid to other states." You responded in the affirmative, because of constitutional law. Please provide a more detailed response. And do states give credit for all taxes paid to other states, or is this limited to certain types of taxes?

Rep. Scott's question was addressed to the question of whether all states give a credit against their use taxes for sales taxes paid to other states and my answer was "yes," because, among other things, they are constitutionally required to do so. The constitutional requirement derives from the Court's "internal consistency" doctrine, which it has articulated under the Commerce Clause.

For a tax to be "internally consistent," its hypothetical replication by every state must result in no greater burden on interstate commerce than on intrastate commerce. "The test … simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage to intrastate commerce." *Oklahoma Tax Commission v. Jefferson Lines, Inc.* 514 U.S. 175, 185 (1995). Use taxes are typically levied on the "storage, use or other consumption" of tangible personal property (and, in some instances, on the use of services) in the state and are measured by the price of the property or services. If replicated by every state, these levies would put the enterprise doing business across state lines at a competitive disadvantage to its wholly intrastate competitor.

If one views use taxes in conjunction with sales taxes for which they compensate, the sales-use tax scheme would subject the purchase of goods in one state that are used in another state to two exactions – a sales tax in the state of purchase and a use tax in the state of use. The purchase of goods or services for local use, however, would be subject to only a sales tax.

If one views use taxes in isolation from sales taxes, use taxes would still subject the interstate business to the risk of multiple taxation not borne by its intrastate competitor. The interstate business using property or services in two or more states would pay a tax in each in each state in which the property or services were used whereas the intrastate business using the property or services in an identical fashion, except that the property or services were not used across state lines, would pay but a single tax. Under either view of the use tax, the competitive "disadvantage" to interstate commerce is self-evident.

The states avoid any "internal consistency" objection to their use taxes by providing a credit for sales or use taxes paid to other states. *See* 2 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 18.08[1] (3d ed. 2002 & Cum. Supp. 2009). They thus assure that the sale or use of property or services is in principle taxed just once whether or not the property or services crosses state lines. While there once may have been some room for debate over the question whether the states were constitutionally compelled to adopt such crediting schemes, the Court's articulation and reaffirmation of the "internal consistency" doctrine should put an end to that debate. As Justice Scalia observed, if the Court "had applied an internal consistency rule" in *Williams v. Vermont*, 472

U.S. 14 (1985), where the Court found it unnecessary to reach the question of whether a state must credit a sales tax paid to another state against its own use tax, "the need for such a credit would have followed as a matter of mathematical necessity." *Tyler Pipe Indus., Inc. v. Washington Dep't of Revenue*, 483 U.S. 232, 255 (1987) (Scalia, J., concurring in part and dissenting in part).

Moreover, the Court's opinion in *Jefferson Lines* reinforces the conclusion that states have a constitutional obligation to provide a credit against their own use taxes for sales or use taxes paid to other states. The Court's strong statements tying its approval of state taxing schemes to the provision of such a credit,[4] and expressing its disapproval of state taxing schemes that fail to provide for such a credit,[5] should lay to rest any doubt that credits for use taxes are constitutionally required.[6]

States also provide credits for personal income taxes paid to other states. As I state in my treatise on state taxation:

> Because the states generally tax residents on their income from all sources while taxing nonresidents on income from sources within the state, and because the Due Process Clause does not forbid multiple taxation of personal income taxpayers deriving income from states other than their own are exposed to the risk that their income will be subjected to duplicative taxation. To deal with this problem, the states provide credits against their personal income taxes for personal income taxes paid to other states. Indeed, every state with a broad-based personal income tax provides a credit for taxes that their residents pay to other states, thereby reverting the final tax to the state that is the source of the taxed income. Some states also provide credits for nonresidents for taxes paid to their home states on income derived from sources within the state of nonresidence,

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[4] The Court declared that "equality of treatment of interstate and intrastate activity has been the common theme among the paired (or 'compensating' tax schemes that have passed constitutional muster." *Jefferson Lines,* 514 U.S. at 193 n.6. It also noted that in upholding taxing schemes providing credits for taxes on in-state transactions, it had "often pointed to the concomitant credit provisions for taxes paid out-of-state as supporting our conclusion that a particular tax passed muster because it treated out-of-state and in-state taxpayers alike." *Id.*

[5] The Court observed that it had "never upheld a tax in the face of a substantiated charge that it provided credits for the taxpayer's payment of in-state taxes, but failed to extend such a credit to out-of-state taxes." *Id.* See also *id.* (observing that under Commerce Clause requirements, use tax "[p]resumably ... would not apply when another State's sales had previously been paid or would apply subject to credit for such payment").

[6] See also *Barringer v. Griffes*, 1 F.3d 1331 (2d Cir. 1993), *cert. denied*, 510 U.S. 1072 (1994) (invalidating under "internal consistency" doctrine Vermont's denial of a credit against the Vermont use tax on motor vehicles registered in the state for sales taxes paid to any other state where the vehicle was previously registered); *Pawa v. McDonald*, 921 F. Supp. 227 (D. Vt. 1996) (invalidating under "internal consistency" doctrine Vermont's denial of exemption from Vermont use tax on intra-family transfers of motor vehicles when such vehicles are registered outside the state); *Arizona Dep't of Revenue v. Arizona Public Serv. Co.*, 934 P.2d 796 (Ariz. App. 1997) (indicating that the failure of a state to grant a credit for its use tax against another state's sales tax would create unconstitutional discrimination); *General Motors Corp. v. City and County of Denver*, 990 P.2d 59 (Colo. 1999) (requiring municipality to provide credit against local use tax for sales and use taxes paid to other states and localities in order to satisfy "internal consistency" doctrine).

> thereby reverting the final tax to the taxpayer's state of residence. All but one of the states that allow credits to nonresidents condition their grant on the reciprocity of the nonresident's home state. Credits may be taken only with respect to the income that is subject to tax by both states, and the credit for the tax paid on the out-of-state income may not exceed the tax imposed on such income by the state granting the credit. In addition, states generally limit the credit to taxes paid to other states during the taxable year for which the credit is claimed.

2 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 20.10[1] (2010) (3d ed. 2003 & Cum. Supp. 2009) (citations omitted).

Other types of taxes do not employ the credit mechanism for avoiding double taxation of interstate transactions or activity. For example, states do not give credits for corporate income taxes paid to other states. Instead, they generally divide (or apportion) income derived from multistate activity among the states in which it is earned. *See generally* 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* chs. 8, 9 (3d ed. 1998 & Cum. Supp. 2009) (citations omitted).

Walter Hellerstein
March 25, 2010

RESPONSE TO POST-HEARING QUESTIONS FROM JOSEPH CROSBY, LEGISLATIVE DIRECTOR, COUNCIL ON STATE TAXATION

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Role of Congress in Defining Nexus
February 4, 2010

Joseph Crosby, Chief Operating Officer and Senior Director, Policy, Council on State Taxation

Questions from the Honorable Steve Cohen, Chairman

1. In your written statement, you suggest that Congress adopt "a national, uniform threshold for the taxation of nonresident workers". Please explain. Should Congress adopt a national, uniform standard for other state taxation situations?

Every business day, thousands of employees across the country are sent by their employers to work in nonresident states. The vast majority of these trips are temporary in nature, whereby the employee conducts business in the nonresident state for a short period of time and then returns to his or her resident state.

Unfortunately, states that impose a personal income tax have diverse rules relating to the obligation of the nonresident employee to file a personal income tax return and to the commensurate employer withholding. Some states impose a personal income tax filing requirement based upon a "first dollar" earned approach with respect to the nonresident employee. Other states set a minimum threshold period of a specific number of days under which the employee is not subject to the nonresident state personal income tax. For example, Arizona and Hawaii have sixty-day thresholds. Some states use an earnings threshold, and yet other states use a combination of day and earnings thresholds.

The challenges imposed upon employees to understand these widely divergent rules, track down the appropriate nonresident state tax forms and actually comply with this multiplicity of state tax rules is nearly insurmountable.

So too, employers are extremely hard-pressed to comply with these varying and disparate rules and provide the appropriate nonresident state tax withholding. It is important to note that this is not only an issue affecting large corporations with thousands of employees travelling for work each year; small businesses, churches and other charitable entities, and even state and local governments struggle mightily in attempting to comply with this regime. There is no readily available technological solution to this problem. Very few large corporations have the capability to integrate payroll with business operating systems to allow tracking of employees' whereabouts on a daily basis in order to comply with the patchwork of nonresident state withholding obligations. The costs of creating such systems would be exorbitant in relation to any compliance gains to the various states. Small business would experience similar issues of undue expense for limited increases in compliance.

Resolution of this issue has reached a critical stage for several reasons. First, employers have a significant interest in ensuring that employees comply with all state law taxation requirements.

COST members are acutely aware of the burdens placed on their employees who travel outside their resident states for business. They have expressed a strong desire to meet their responsibilities as employers by assuring their employees comply with these burdens.

Second, Section 404 of the Sarbanes Oxley Act of 2002 requires company management to certify that processes and procedures are in place to comply with applicable laws and regulations, including state tax laws. This provision, along with a commensurate desire by corporations to be fully compliant with all rules and requirements as part of corporate governance responsibilities, has increased the interest by employers in seeking uniformity and simplicity in matters of nonresident state income tax and withholding laws.

Third, COST members have noticed an increasing amount of state audit activity focusing on nonresident income tax withholding requirements. While these audits appear to be limited to a few states, this development highlights the need for Congress to take action now on this issue.

With regard to the second part of this question, whether Congress should adopt a national, uniform standard for other state taxation issues, the answer is clearly "yes" for business activity tax nexus. While different taxes and different industries may warrant different levels of national uniformity, the fundamental issue of when a state (or locality) can impose a tax obligation on an interstate (or foreign) business certainly cries out for Congressional action. This is because the extent of a state's jurisdiction in our federal system of government overarches all technical taxing sub-issues.

2. Professor Hellerstein suggests in his written statement that physical presence is a poor litmus test for sensible state tax nexus rules. Do you agree? Why?

In his written statement, Professor Hellerstein said: "I would like simply to leave the Subcommittee with some thoughts about the sense – or nonsense – of relying on physical presence as a test for nexus in *one* context: use tax collection obligations" [emphasis added].

COST has long supported Congressional action in the area of use tax collection. The COST Board of Directors has adopted a formal policy position on the simplification of the sales and use tax system. That position is as follows:

> *A sales and use tax must be easily administered, easily understood by consumers, and nondiscriminatory between similarly situated vendors, purchasers, and goods. The Congress must enact legislation that: 1) establishes precise standards and a governance mechanism by which the States would radically simplify and reform the sales and use tax system for all vendors and purchasers; and 2) remove existing limitations on the authority of States to compel remote vendors to collect and remit sales and use taxes for those States that radically simplify their sales and use tax systems.*

3. Why do you contend that "physical presence is the appropriate nexus standard for the imposition of direct taxes on business"?

The U.S. Supreme Court has ruled that for all state and local impositions, there must be substantial nexus between the state and the taxpayer. In the area of sales and use tax, the Court has ruled that substantial nexus requires physical presence. There currently is a great amount of discussion and debate throughout the tax community, in the Congress, and elsewhere regarding the appropriate nexus standard for business activity taxes.

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.

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. The standard should also prohibit states from attributing nexus between entities absent an express or implied agency relationship (where the activities of the agent may otherwise potentially create nexus for the principal). 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.

4. Your constituency is the business community. As a voice for the business community, please explain for us why Congress should address the legislative proposals before us.

H.R. 2110, the Mobile Workforce State Income Tax Fairness and Simplification Act, would provide significant tax administrative relief to businesses (and workers) without imposing any burden on the states or materially affecting state tax revenues. In previous testimony to this Subcommittee, the Federation of Tax Administrators stated: "Complying with the current system is…indeed difficult and probably impractical."[1] H.R. 2110 would make compliance possible for employers and their employees, and COST urges the Subcommittee to act on this bill.

The Subcommittee should also act on H.R. 1083, the Business Activity Tax Simplification Act. States seeking to overstep their jurisdiction to impose taxes on those who are outside their borders has been a problem since this country was founded. Interstate taxation was a major reason the Articles of Confederation were replaced by the Constitution and its Commerce Clause. In 1959, Congress enacted P.L. 86-272 to address the federal government's concern with states overreaching in their effort to impose tax on interstate businesses, but states have only more aggressively expanded their tax jurisdiction over the intervening decades. Finally, some foreign countries have pointed to the promotion of so-called "economic nexus" by state tax officials as an excuse to abandon the permanent establishment rule in the context of international

[1] Statement of Harley Duncan before the House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, November 1, 2007.

trade and tax treaties. The health of our country's economy is vital to all, and H.R. 1083 would foster investment by setting a clear and appropriate standard for state tax jurisdiction.

5. You suggest that unclear state tax nexus standards burden interstate commerce. Do you have accurate numbers on how much that burden affects interstate commerce? How would Congress' establishing state tax nexus rules lessen the burden on interstate commerce? Would it depend on what rules Congress established?

COST has been unable to quantify the harm that unclear nexus standards have on interstate (and international) commerce, but we have much anecdotal evidence that the states' aggressive pursuit of "economic nexus" often stymies new investment and wastes resources that could be dedicated to more productive uses. With a uniform physical presence rule, businesses—and state governments—would know, with certainty, when tax obligations arise. Rules based on something other than physical presence would not provide relief because they would not curb states' continued attempts to export tax burdens.

6. You indicate that "the states and the business community have come together to address the undue burden on interstate commerce identified in the Quill decision." Presumably you are describing the establishment of the Streamlined Sales and Use Tax Agreement. Many businesses have urged Congress to address state business activity taxes, a much different issue than that found in Quill. Can the business community and the states work together on business activity taxes? Why or why not?

The Streamlined Sales Tax effort involves a very large number of compliance and administrative issues. Although these issues are complex, they are solvable. The nature of sales tax collection provides incentives for disparate parties to cooperate toward a common goal. These incentives include increased levels of compliance with use taxes (and a commensurate increase in revenue collected), reduced sales tax compliance costs and reduced market distortions that result from tax collection decisions.

In contrast, business activity tax nexus is a single, clean jurisdictional question with only two possible answers: a state can tax an interstate business with no physical presence within the state's borders or a state cannot tax in such a situation. As a result, numerous discussions over many years between representatives of the states and the business community have failed to reach any compromise.

7. You suggest that "one size does not fit all" as a solution to state tax nexus issue. What do you propose as the best standard for each of the situations addressed by the legislative proposals before the Committee? Income tax situations? Transactional tax situations?

It is essential to focus on who bears the burden of a specific tax. In the context of the corporate income tax and other business activity taxes, the business upon which the tax is imposed bears the burden. H.R. 1083, which defines a physical presence nexus standard, is appropriate for business activity taxes.

In contrast, the sales and use tax is (ordinarily) imposed on the purchaser. The issue here is under what circumstances a state can require a business without a physical presence in a state to collect tax from buyers within the state's borders. In other words, the sales tax concern is not on imposing tax on those outside the taxing jurisdiction's borders; rather, the concern is when the out-of-state business can be asked to collect and remit taxes. The Congress should enact legislation specifying the parameters of a simple sales and use tax system—one that minimizes the collection burden on sellers—and allow states that adopt such a system to require all sellers to collect tax.

With regard to personal income taxes imposed on a nonresident employee who works in a state for a brief period of time, the problem is not that the state's tax jurisdiction over the nonresident employee is unclear. The concerns here stem from the multiplicity of jurisdictions that have the authority to tax the same income and the administrative burdens imposed on employee and employers by the crazy-quilt of state personal income tax laws. Thus, COST supports H.R. 2110, which would prohibit states from imposing personal income taxes on nonresident employees who are in a state for 30 or fewer days.

8. During the hearing, Commissioner Bruce Johnson discussed a uniform nexus standard devised by the Multistate Tax Commission. Please provide your thoughts on the standard. Is it a fairer standard than what the states currently utilize?

Commissioner Johnson discussed a standard proposed by the Multistate Tax Commission (MTC) that would assert nexus over any company that has a sufficient level of property, payroll *or* sales into a state. In other words, it is simply a quantitative rendering of an economic nexus standard. COST opposes an economic nexus standard, however formulated. Such a standard is unfair because it would allow states to impose tax on a business that merely has customers within the jurisdiction rather than only on businesses that are physically present in the state. Moreover, the majority of states still follow the traditional physical presence rule, and thus the MTC's approach would result in an expansion of an inappropriate rule. Finally, expansion of the MTC proposal may encourage some of our international partners to press to abandon the current permanent establishment standard for international tax jurisdiction.

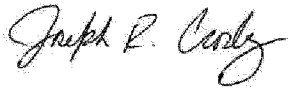
9. During Commissioner Johnson's testimony, he gave an example of two banks, one located in Utah, and the other located in another state, to depict what he deems the unfairness in the inability of states to tax some out-of-state businesses. He asked: "Does it make sense that one bank has to pay income tax on all of that money and the other bank doesn't? Why should an out-of-state bank be able to come in, exploit the Utah market, and not have to pay an income tax on the income it derives from the Utah market?" Please respond.

Commissioner Johnson's testimony revealed a fundamental misunderstanding of economics: income is earned where capital (property) and labor (payroll) is employed, not where sales are made. The bank earns its income, as explained above, where it employs its people and its property. In Commissioner Johnson's example, the out-of-state bank should, and certainly does, pay taxes to the state where it is located, just as does the bank located in Utah. Each bank pays

tax to the state in which it has made its investments and from which it receives benefits and protections.

Once again, I sincerely appreciate the opportunity to comment on these pressing issues of national importance. I would be pleased to submit any further information or analysis the Subcommittee would find helpful.

Sincerely,



Joseph R. Crosby

RESPONSE TO POST-HEARING QUESTIONS FROM R. BRUCE JOHNSON, COMMISSIONER, UTAH STATE TAX COMMISSION

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Role of Congress in Defining Nexus
February 4, 2010

R. Bruce Johnson, Commissioner, Utah State Tax Commission

Questions from the Honorable Steve Cohen, Chairman

1. In his written statement, Mr. Crosby asserts that the "primary motivation for expanded state tax jurisdiction is to generate additional tax revenue", not to provide "clarity and certainty". Is he correct?

The primary reason for expanded state tax jurisdiction is to ensure that the tax burden in a particular state is fairly distributed among the people and entities doing business in that state and to enhance the stability of revenues generated from the tax system. In times of surpluses, expanded jurisdiction may result in lower tax rates for all taxpayers, whether physically located in the state or not, that benefit from the state's markets. During budget shortfalls, such as most states are currently experiencing, expanded state tax jurisdiction may well generate additional needed revenues. Just as importantly, the ability to tax all activity in the state helps to make the tax system more stable during such times. Appropriate nexus standards must be fair to both taxpayers and the states throughout the business cycle, in times of economic hardship and in times of economic plenty. A nexus standard that clarifies that a business is subject to tax if it is selling goods or services into a particular state and thereby exploiting the market in that state, will raise revenue, but it will also provide clarity and certainty for those businesses, and, equally importantly, will put them on a level playing field with Main Street competitors.

2. Mr. Crosby suggests in his written statement that unclear state tax nexus standards burden interstate commerce and urges Congress to address the issues. Do you agree that the uncertainty is a burden? How would Congress' establishing state tax nexus rules lessen the burden, if there is one, on interstate commerce? Would it depend on what rules Congress established?

Uncertainty in taxation is a burden both for taxpayers and tax administrators. We all benefit when the law is clear, and each taxpayer's obligations are well understood. Whether federal nexus rules lessen uncertainty would depend on what rules Congress established. For example, the so-called "physical presence" standard in the Business Activity Tax Simplification Act (HR 1083) would not reduce uncertainty. Under PL 86-272, as currently in effect, a taxpayer may have physical presence in a state and still not be subject to taxation if the taxpayer's full-time employees in the state limit their the activities to "mere solicitation." That standard is not at all clear. See, *Wisconsin Dep't of Revenue v. William Wrigley, Jr.,*, 505 U.S. 214 (1992). Under BATSA, that same unclear standard would be applied to a larger segment of the business community. Moreover, the physical presence standard, as currently proposed, has numerous exemptions and carve-outs. Judicious taxpayers would feel compelled to engage in myriad kinds of entity restructuring to benefit from the various safe harbors present in the legislation.

A better standard would be the "factor presence" standard promulgated by the Multistate Tax Commission, a copy of which is attached. Multistate Tax Commission Policy Statement 2002-02, as amended July 31, 2008. Under this standard, any taxpayer that had more than $500,000 of sales into a state would know that it was subject to do income taxation by that state. If it had less than $50,000 in payroll in the state, less than $50,000 of property in the state, and less than $500,000 in sales in the state, it would have no income tax obligation. A taxpayer with a large economic presence in the state would know that it would be subject to tax and could conduct business freely with that knowledge. It

would not have to follow a tax lawyer's detailed memorandum on how to avoid "physical presence" or some other artificial test.

In the Mobile Workforce State Income Tax Fairness and Simplification Act (HR 2110), a minimum number of days "bright line" does make sense and would reduce uncertainty and a taxpayer's burden. As noted in our testimony, we believe a 20-day test, that would equate to a normal 4 week period, is sufficient to provide taxpayers with the certainty they need without unduly reducing a state's right to collect income tax on employees working within its boundaries.

3. Imagine that Congress addresses the state tax nexus issues before us and establishes a physical presence standard for the income taxation of businesses and for the taxing of transactions. How would this affect state and local government revenues? Do you have accurate numbers on the effect of establishing such a standard?

There is no doubt that state and local government revenues would fall considerably. The Congressional Budget Office prepared an analysis in 2006 on the predecessor of BATSA (HR 1956, 2005) that indicated the loss could be as great as $ 3 billion annually. The CBO analysis ***did not*** take into account the various loopholes and exclusions in BATSA that large multistate taxpayers could avail themselves of with careful tax planning.

A more detailed study conducted by the National Governors Association (NGA) concluded that H.R. 1956, if enacted, would result in revenue losses, in fiscal 2007, ranging from $4.7 billion to a maximum of $8.0 billion with a "best estimate" of $6.6 billion. These revenue impacts were projected to increase in the subsequent fiscal years as additional firms took advantage of the "loopholes" and carve outs included in that bill.

We believe the NGA study to be more accurate than the CBO study because it is based on surveys of the revenue estimating staffs of state revenue agencies. These individuals have access to the actual tax returns filed by business taxpayers and thus are acutely aware of the intricate business structures some firms use to minimize or eliminate tax liabilities in their respective states. Further, interviews with professors of Accounting at a number of universities confirmed that these sophisticated business structures do in fact exist; and, that firms would have a fiduciary responsibility to their shareholders to avail themselves of the tax avoidance "loopholes" available to them under this bill (H.R. 1083).

We do not have an independent estimate of the revenue impact of imposing a congressionally mandated physical presence nexus standard for the collection of state and local sales and use taxes. However, we do have an estimate of the revenue loss resulting from state and local government inability to collect sales/use tax from electronic commerce ("State and Local Government Sales Tax Revenue Loss from Electronic Commerce," Donald Bruce, William F. Fox, and LeAnn Luna, The University of Tennessee, April 13, 2009). Professors Bruce, Fox, and Luna estimated that under their baseline scenario of the growth of e-commerce, state and local government revenue losses were $7.2 billion in 2007 but would rise to $11.4 billion in 2012. These estimates may be at the high end because a significant amount of use taxes are self-reported by businesses and not collected and remitted by the vendors; and, an additional amount will be collected on audit. Compliance with use tax laws on the part of individuals is assumed to be negligible. In Utah, for example, use tax was reported on about 6,000 individual income tax returns for 2007 out of over 1,000,000 filed—or about 6/10ths of 1%. The total amount reported was about $320,000. The Streamlined Sales Tax Project is designed to facilitate compliance of retailers selling electronically to individuals.

4. Mr. Crosby in his written statement suggests that "one size does not fit all" as a solution to state tax nexus issue. Do you agree? What do you propose as the best standard for each of the situations addressed by the legislative proposals before the Committee? Income tax situations? Transactional tax situations?

I agree that one size does not fit all. Our economy is very complex, and our tax system is very complex. For business activity type taxes, I have already indicated that I believe that the MTC approach is sound. I note, however, that the states would prefer to adopt the standard individually, rather than having it mandated by the federal government. On streamlined sales tax, there is a general consensus among the states and the business community that there should be a "small seller" exemption. At this time, there is no consensus among the states or in the business community as to what the appropriate level should be. On the Mobile Workforce Legislation, I believe that a 20-day period is appropriate, as long as the exceptions remain for high-income individuals. I note, however, that not all states would agree.

5. The hearing focused on the concept of nexus, and Congress' authority to establish state tax nexus standards. In your written statement, you suggest that Congress should also consider the founding of this country when discussing nexus. Please explain.

Under the Constitution, the states ceded a substantial amount of authority to the new federal government. The powers that were not specifically ceded, however, remained in the states. For much of our history, state and local government assumed most of the burden for their citizens' health and welfare. As the government closest to the people, they are frequently in the best position to determine what those specific needs are. It is axiomatic that the states need to raise their own source revenue to provide for those needs. The taxing power is an inherent and necessary attribute of sovereignty. In the absence of compelling reasons to the contrary, the states should have the ability to determine an appropriate tax burden for all entities doing business within their borders, including any entity that makes sales of goods or services into the state. The Supreme Court has clearly held that the Constitution contemplates that interstate commerce should pay its fair share of the state tax burden. See *Western Livestock v. Bureau of Revenue*, 303 U.S. 250 (1938); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The federal government has a legitimate role in preventing state taxation that discriminates against interstate commerce. It also has an appropriate role in limiting state taxation that unduly burdens interstate commerce. That power, however, should be exercised only when clearly necessary to prevent the Balkanization of commerce feared by the founders. It should not be used to create tax-free zones in which car rental companies, hotel intermediaries, or large financial institutions can operate with state tax impunity.

6. Although the states and the business community have established the Streamlined Sales Tax Project, Congress would still need to give its blessing to it. Instead of doing so, should Congress just address Quill and establish a standard which allows states to require remote sellers to collect and remit use taxes? What difficulties do you see arising if Congress took this route?

Congress can certainly overturn *Quill* without requiring any simplification or uniformity from the states. Many states would encourage Congress to do so. Similarly, some businesses would resist overturning *Quill*, no matter what standards Congress enacted. When so many members of the business community have worked for years with the states to craft compromises that address both sides' concerns in a reasonable manner, I believe it would be unwise for Congress to unilaterally reject the results of that effort. There are surprisingly few issues remaining to be resolved.

If those remaining issues cannot be resolved by the cooperative effort of the business community and the states, then it may be time for Congress to act to break the deadlock, but in doing so it should build on the important work that has already been done.

7. In your opinion, looking at this from a policy perspective, not a states' rights perspective, what should Congress do regarding state tax nexus rules? What is the fairest rule? The simplest rule?

In taxation, fairness is often the enemy of simplicity and *vice versa*. In this case, however, I believe the two principles can be reconciled. All taxpayers exploiting the market in any state should be subject to the same taxes, computed in the same manner. It would be fair because all would have the same burden. It would be simple because taxpayers would no longer have to worry about "how much contact is too much." They could conduct business untrammeled by such concerns. If they wanted to visit a client or put a distribution center in a given state, they could do so without dramatically changing their tax profile. The only rules that would be needed would be reasonable *de minimus* rules to avoid an undue burden on small businesses or even large business that had only incidental contacts with the state.

In the Sixties, the Willis Committee proposed a federal income tax apportionment scheme for interstate businesses.[1] In response, the states adopted the Multistate Tax Compact and the Uniform Distribution of Income for Tax Purposes Act ("UDITPA"), which resolved many of the issues that concerned the Willis Committee. Although states have adopted various modifications of the three-factor formula proposed in UDITPA, most of the operational rules for computing the factors remain in place and are consistent among large numbers of states.

In the Mobile Telecommunications Sourcing Act (P.L. 106-252), the states and businesses came together to craft uniform rules to determine which state could impose its tax on mobile telecommunications services which, by definition, had no fixed place of use. After this cooperative effort, Congress enacted the provisions into law.

Similarly, the states and businesses are working together to craft the Simplified Sales and Use Tax Agreement. Although that Agreement, without Congressional ratification, still provides a useful guide for states in simplifying their taxes and making them more consistent with other states' laws, the states collectively cannot overturn *Quill*. It is unlikely that the states will have the political will to remain uniform in the future if Congress does not ratify the Agreement and require remote vendors to collect participating states' sales taxes.

States' rights cannot be divorced from "policy." The appropriate policy is one that balances states' rights with taxpayers' rights. In most cases, I believe Congress should defer to the states and the taxpayers to work out appropriate solutions. Then, if necessary, Congress can add its imprimatur.

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[1] Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary, "State Taxation of Interstate Commerce," H.R. Rep. No. 480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965).

ATTACHMENT

Multistate Tax Commission Policy Statement 2002-02, Amended October 17, 2002 and Amended July 31, 2008

2002-02 Ensuring the Equity, Integrity and Viability of State Income Tax Systems

2.1 Preamble

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

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

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

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

approximately $6 billion of additional revenue lost at the state level. Federal efforts to solve the transfer pricing and other international income shifting problems have been ineffective.

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

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

2.2 Federal Support for Ensuring Full Accountability of Income Reporting

The Multistate Tax Commission strongly supports efforts by federal and state governments to enact legislation and regulations to insure full accountability in income reporting by individuals and business entities. The federal government asked the states to refrain from the use of worldwide combined reporting on the basis that the states should allow the federal government to handle international division of income issues. In exchange, the states were promised improved federal efforts to solve international income reporting problems and federal assistance in administering their corporate tax systems, including a federally-administered "domestic disclosure spreadsheet" to document the state income tax reporting practices of corporations. While the states honored the federal government's request to refrain from using worldwide combined reporting, the federal support for the states has not been forthcoming. Moreover, the federal efforts to resolve the international income reporting problems remain inadequate because they are based on an "arms length" method of accounting that simply does not work in either theory or practice in the context of the modern global economy. The federal government should honor its earlier promises to the states of support for corporate income tax administration. The federal government should recognize as well the superiority of formula apportionment over arms length accounting and adopt methods of dividing international income pioneered and effectively applied by the states. Finally, the federal government should continue to upgrade its general efforts to counteract abusive tax shelter activity that undermines both federal and state income tax systems.

Specifically, Congress should undertake the following steps to ensure the proper reporting of income:

- Enact legislation to undertake an orderly process of converting to formula apportionment on a worldwide basis employing the unitary business principle as the correct approach to properly dividing the income of multinational enterprises.

- Enact legislation that eliminates the tax benefits from "corporate inversions" under which U.S. corporations incorporate in off-shore tax havens to escape federal and state corporate income taxes while continuing to operate in the United States. Such legislation would be a transition measure until the federal government fully converts to a formula apportionment system applied on a worldwide basis.

- Enact legislation requiring multijurisdictional taxpayers to file with the IRS a domestic disclosure spreadsheet. Each spreadsheet would list the taxpayer's liability in each state in which it operates and disclose the method of calculation used to reach the result. The IRS would review the spreadsheets for accuracy and would share information contained on the spreadsheets with the states. The information should be shared under exchange of information agreements that support cooperative work by the states through the Commission or other joint instrumentalities to ensure the proper reporting of income. This measure would strengthen the ability of states to ensure proper corporate income reporting. It would provide a basis for a stronger partnership between the federal government and the states in working to curb abusive tax shelter activity.

- Enact federal legislation to impose effective penalties on taxpayers for failure to properly report income and on investors in and promoters of transactions the primary purpose of which is tax avoidance. Such legislation will encourage the proper reporting of net income for both federal and state income tax purposes. Enact federal legislation that prohibits taxpayers from relying on opinions written by tax advisors who benefit from contingency fee arrangement in which the tax advisor receives a portion of the tax savings from the tax planning methods on which they offer advice. This legislation is necessary and important to help restore integrity to the tax system.

- Study methods of bringing into closer alignment statements of book income and taxable income and then take action to implement the most promising methods. Sophisticated accounting methods are increasingly used to inflate book income and deflate taxable income. Strengthening links between book income and taxable income will help restore integrity to accounting for both.

To improve coordination with the federal government on curtailing international and domestic tax shelter activities, the Commission commits itself to assisting the federal government in developing a system of formula apportionment at the international level. Further, the states should consider the development of a process that parallels the federal process of requiring those who engage in abusive tax shelters to disclose those tax shelters for review in advance of the normal audit process. Such a process would build on the federal process and would focus on domestic tax shelter activities that shift income away from where it was earned to tax haven locations or to being reported nowhere.

2.3 Opposing Federal Efforts to Restrict State Business Tax Authority

The Multistate Tax Commission strongly opposes federal legislation that infringes upon state authority to tax a fair share of interstate commerce. Currently, legislation is pending in Congress that would impose a federal nexus standard of substantial physical presence for imposition of business activity taxes. The U.S. Supreme Court has upheld on numerous occasions that the nexus standard for business activity taxes is not based upon a concept of physical presence, but instead is based on the privilege of engaging in business in the state. Further, the Court has never ruled that a business must have "substantial physical presence" in a state before it can be subjected to state taxing jurisdiction. In addition, the proposed federal legislation not only would impose a general physical presence standard, it would also create a list of "tax haven activities" that would allow a company to avoid the jurisdiction of a state despite engaging in income-producing activity there.

Nexus standards for the imposition of business activity taxes based on physical presence will legalize and expand the use of abusive tax shelter activities that are already undermining the equity, integrity and viability of state business activity taxes. The list of "tax haven activities" offers a specific blueprint for shifting income away from where it is earned to tax favored locations. The physical presence standard and the list of "tax haven activities" will allow many out-of-state enterprises that earn income from within a state and benefit from the services the state provides to escape paying a fair share of the cost of those services. Imposition of new limits on state business activity taxing authority by requiring an untested level of physical contacts by a taxpayer will inevitably lead to lengthy and expensive litigation to determine the full meaning of such laws. Finally, physical presence nexus standards discourage the flow of investment across state boundaries, and subvert national economic growth and balanced economic development among all geographic regions of the nation.

Instead of undermining the proper operation of state business activity taxes, the Congress should undertake the measures outlined above that would establish a cooperative federal-state framework for ensuring the proper accountability of income.

2.4 Commission Support for Simple, Certain and Equitable Factor Presence Nexus Standard for Business Activity Taxes

The Multistate Tax Commission and its member states devote extensive efforts to improving the accountability of income earned by multijurisdictional enterprises. The federal proposals for limiting state business taxes through a restrictive nexus standard run counter to those efforts. At the same time, the Commission recognizes the need to provide taxpayers with clear guidelines regarding the jurisdictional standards for business activity taxes that would serve to protect multijurisdictional businesses from the burden of filing taxes in states in which they have only minor activity. The Commission has developed a factor presence nexus standard for imposition of income and franchise taxes that is certain and clear and fairly represents where an entity is doing business and earning income. This standard uses a threshold dollar amount of any of the apportionment factors of property, payroll or sales to determine nexus. The U.S. Supreme Court has long recognized property, payroll and sales as indicative of where a company is engaging in business and earning income.

The Commission normally urges adoption of such uniformity proposals by the States. It is certainly appropriate for states to adopt the factor presence nexus standard to better guide businesses on when nexus attaches for business activity taxes. But for many states congressional preemption of state authority to tax interstate commerce in P.L. 86-272 interferes with effective implementation of the factor presence nexus standard. P.L. 86-272 bars states from imposing a net income tax on the income derived within a state from interstate commerce if a person's only business activity is the solicitation of orders for sales of tangible personal property. The law was intended to be a temporary measure to protect small businesses while Congress studied state taxation of interstate commerce. Actions by the states enacting the Uniform Division of Income for Tax Purposes Act and the Multistate Tax Compact sufficiently rationalized and simplified states' imposition of income taxes to forestall further congressional action. P.L. 86-272 remains in place. Rather than simplify the law, it has been the source of litigation in hundreds of cases. Rather than protect small businesses, it has been used to protect major multistate businesses from paying their fair share of taxes on interstate commerce to the various states in which they do business.

The Commission endorses the superiority of the factor presence nexus standard in protecting small businesses, in requiring large businesses to pay their fair share of tax, in providing a simple and certain mathematical standard for multistate taxpayers and in reducing litigation. Because P.L. 86- 272 interferes with the proper working of the factor presence standard, and because even the states acting together through a uniformity provision cannot remove that interference, the Commission urges Congress to enact a provision that relieves a state of the application of P.L. 86-272 if the state has enacted the factor presence nexus standard with specified thresholds. A copy of the factor presence nexus standard is attached. Such an action by Congress would provide an effective foundation for uniform action by the states to help restore greater equity and integrity to the reporting of business income for state tax purposes.

2.5 Opposing Federal Efforts to Restrict State Individual Income Tax Authority

The Multistate Tax Commission strongly urges Congress to respect the sovereignty of states in exercising their jurisdiction to impose individual income taxes within constitutional limits. The Multistate Tax Commission is prepared to assist states in developing uniform *de minimis* thresholds for withholding obligations on tax due from multistate individual income taxpayers.

2.6 Commitment to Educating Constituencies

One of the most important roles that the Multistate Tax Commission fulfills is that of educating constituencies on issues of taxation. Understanding the underlying principles of state corporate income taxes is a difficult task. The Commission commits itself to providing education and guidance to taxpayers, federal and state government officials and all other interested parties concerning:

- current issues in corporate income tax law,
- suggestions by which these laws can be improved, and
- how current law and other proposals affect state and local tax systems.

To be effective through Annual Meeting 2013.

Factor Presence Nexus Standard for Business Activity Taxes

Approved by the Multistate Tax Commission October 17, 2002

A. (1) Individuals who are residents or domiciliaries of this State and business entities that are organized or commercially domiciled in this State have substantial nexus with this State.

(2) Nonresident individuals and business entities organized outside the State that are doing business in this State have substantial nexus and are subject to [list appropriate business activity taxes for the state, with statutory citations] when in any tax period the property, payroll or sales of the individual or business in the State, as they are defined below in Subsection C, exceeds the thresholds set forth in Subsection B.

B. (1) Substantial nexus is established if any of the following thresholds is exceeded during the tax period:

(a) a dollar amount of $50,000 of property; or

(b) a dollar amount of $50,000 of payroll; or

(c) a dollar amount of $500,000 of sales; or

(d) twenty-five percent of total property, total payroll or total sales.

(2) At the end of each year, the [tax administrator] shall review the cumulative percentage change in the consumer price index. The [tax administrator] shall adjust the thresholds set forth in paragraph (1) if the consumer price index has changed by 5% or more since January 1, 2003, or since the date that the thresholds were last adjusted under this subsection. The thresholds shall be adjusted to reflect that cumulative percentage change in the consumer price index. The adjusted thresholds shall be rounded to the nearest $1,000. As used in this subsection, "consumer price index" means the Consumer Price Index for All Urban Consumers (CPI-U) available from the Bureau of Labor Statistics of the United States Department of Labor. Any adjustment shall apply to tax periods that begin after the adjustment is made.

C. Property, payroll and sales are defined as follows:

(1) Property counting toward the threshold is the average value of the taxpayer's real property and tangible personal property owned or rented and used in this State during the tax period. Property owned by the taxpayer is valued at its original cost basis. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period; but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

(2) Payroll counting toward the threshold is the total amount paid by the taxpayer for compensation in this State during the tax period. Compensation means wages, salaries,

commissions and any other form of remuneration paid to employees and defined as gross income under Internal Revenue Code § 61. Compensation is paid in this State if (a) the individual's service is performed entirely within the State; (b) the individual's service is performed both within and without the State, but the service performed without the State is incidental to the individual's service within the State; or (c) some of the service is performed in the State and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the State, or (2) the base of operations or the place from which the service is directed or controlled is not in any State in which some part of the service is performed, but the individual's residence is in this State.

(3) Sales counting toward the threshold include the total dollar value of the taxpayer's gross receipts, including receipts from entities that are part of a commonly owned enterprise as defined in D(2) of which the taxpayer is a member, from

(a) the sale, lease or license of real property located in this State;

(b) the lease or license of tangible personal property located in this State;

(c) the sale of tangible personal property received in this State as indicated by receipt at a business location of the seller in this State or by instructions, known to the seller, for delivery or shipment to a purchaser (or to another at the direction of the purchaser) in this State; and

(d) The sale, lease or license of services, intangibles, and digital products for primary use by a purchaser known to the seller to be in this State. If the seller knows that a service, intangible, or digital product will be used in multiple States because of separate charges levied for, or measured by, the use at different locations, because of other contractual provisions measuring use, or because of other information provided to the seller, the seller shall apportion the receipts according to usage in each State.

(e) If the seller does not know where a service, intangible, or digital product will be used or where a tangible will be received, the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is available from the business records of the seller maintained in the ordinary course of business when such use does not constitute bad faith. If that is not known, then the receipts shall count toward the threshold of the State indicated by an address for the purchaser that is obtained during the consummation of the sale, including the address of the purchaser's payment instrument, if no other address is available, when the use of this address does not constitute bad faith.

(4) Notwithstanding the other provisions of this Subsection C, for a taxpayer subject to the special apportionment methods under [Multistate Tax Commission Regulations IV.18.(d) through (j)], the property, payroll and sales for measuring against the nexus thresholds shall be defined as they are for apportionment purposes under those regulations. Financial institutions subject to an apportioned income or franchise tax shall determine property, payroll and sales for nexus threshold purposes the same as for apportionment purposes under the [MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions]. Pass-through entities, including, but not limited to, partnerships, limited liability companies, S corporations, and trusts, shall determine threshold amounts at the entity level. If property, payroll or sales of an entity in this State exceeds the nexus threshold, members, partners, owners, shareholders or beneficiaries of that pass-through

entity are subject to tax on the portion of income earned in this State and passed through to them.

D. (1) Entities that are part of a commonly owned enterprise shall determine whether they meet the threshold for nexus as follows:

(a) Commonly owned enterprises shall first aggregate the property, payroll and sales of their entities that have a minimum presence in this State of $5000 of combined property, payroll and sales, including those entities that independently exceed a threshold and separately have nexus. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. If that aggregation of property, payroll and sales meets any threshold in Subsection B, the enterprise shall file a joint information return as specified by the [tax agency] separately listing the property, payroll and sales in this State of each entity.

(b) Those entities of the commonly owned enterprise that are listed in the joint information return and that are also part of a unitary business grouping conducting business in this State shall then aggregate the property, payroll and sales of each such unitary business grouping on the joint information return. The aggregate number shall be reduced based on detailed disclosure of any intercompany transactions where inclusion would result in one State's double counting assets or revenue. The entities shall base the unitary business groupings on the unitary combined report filed in this State. If no unitary combined report is required in this State, then the taxpayer shall use the unitary business groupings the taxpayer most commonly reports in States that require combined returns.

(c) If the aggregate property, payroll or sales in this State of the entities of any unitary business of the enterprise meets a threshold in Subsection B, then each entity that is part of that unitary business is deemed to have nexus and shall file and pay income or franchise tax as required by law.

(2) "Commonly owned enterprise" means a group of entities under common control either through a common parent that owns, or constructively owns, more than 50 percent of the voting power of the outstanding stock or ownership interests or through five or fewer individuals (individuals, estates or trusts) that own, or constructively own, more than 50 percent of the voting power of the outstanding stock or ownership interests taking into account the ownership interest of each such person only to the extent such ownership is identical with respect to each such entity.

E. A State without jurisdiction to impose tax on or measured by net income on a particular taxpayer because that taxpayer comes within the protection of Public Law 86-272 (15 U.S.C. § 381) does not gain jurisdiction to impose such a tax even if the taxpayer's property, payroll or sales in the State exceeds a threshold in Subsection B. Public Law 86-272 preempts the state's authority to tax and will therefore cause sales of each protected taxpayer to customers in the State to be thrown back to those sending States that require throwback. If Congress repeals the application of Public Law 86-272 to this State, an out-of-state business shall not have substantial nexus in this State unless its property, payroll or sales exceeds a threshold in this provision.

PREPARED STATEMENT OF 303 PRODUCTS, INC.

303 PRODUCTS, INC.

Testimony of 303 Products. Inc.
United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law
February 4, 2010

Chairman Cohen, Ranking Member Franks and Members of the Subcommittee, thank you for holding a hearing on "State Taxation: The Role of Congress in Defining Nexus."

303 Products, Inc. is a small company established in 1980 and incorporated in California in 1990. We manufacturer several aftermarket products sold in marine, automotive, outdoor fabrics and other aftermarkets throughout the US. We have a great workforce. Our products are recommended by manufacturers and make life easier and better for thousands of consumers because they actually work to safely and effective clean and then protect plastics, rubbers and textiles that otherwise degrade when exposed to the elements.

Although I understand that this hearing is not focusing on any specific legislation pending before the Committee, I would like to take this opportunity to respectfully urge that the Committee consider and favorably report out H.R. 1083, the Business Activity Tax Simplification Act of 2009. As you know, that bill would resolve current uncertainly and unfairness associated with varying nexus rules applied by the states with respect to the taxation of the income of nonresident companies. That uncertainty and unfairness has a significant negative impact on interstate commerce, and the burdens it creates, especially those caused to small businesses, increase exponentially as more time passes without a federally mandated solution to the problem.

H.R. 1083 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. 1083 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

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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.

303 Products is committed to paying all tax rightfully owed. But, clear, predictable and equitable standards for state taxation of interstate business are essential to drive the economy for the benefit of consumers and businesses, large and small. Unless Congress acts quickly to enact H.R. 1083, our business and others that operate across state lines will continue to suffer contractions of investments, employment and profit. Given the current state of the economy, that scenario presents a real threat to our survival.

Thank you for the opportunity to comment.

Yours truly,
303 PRODUCTS, INC.

Dennis A. Praegitzer

Dennis A. Praegitzer
President/CEO

PREPARED STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

February 4, 2010

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

February 4, 2010

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
February 4, 2010

The American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record for the hearing entitled State Taxation – The Role of Congress in Defining Nexus. In particular, ABA would like to express our support for the Business Activity Tax Simplification Act of 2009 (BATSA, H.R. 1083).

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 more than 2 million men and women.

Today, banks of all sizes face the difficulties associated with the uncertainty of states' business activity taxes. The differences in the application of the tax greatly increase 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 can only 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:

- Inconsistent and unclear taxation standards between states subject businesses to litigation and other onerous business costs, which are especially harmful to small businesses.

- Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs.
- BATSA will help minimize litigation costs and uncertainty for businesses by clarifying that entities must have a physical presence in the taxing jurisdiction in order to be subject to state and local taxes.

I. Inconsistent and unclear taxation standards between states subject businesses to litigation and other onerous business costs, which are especially harmful to small businesses.

An increasing number of states have enacted, or are considering, legislation that would lower the threshold of what constitutes "substantial nexus" for purposes of taxing 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.

The 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' economies 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 would also include a bright-line test that would establish a minimal amount of activity a business must perform in a state before it is subject to income taxes and additional paperwork. Finally, this bill would help limit businesses' exposure to unanticipated taxes, and thus reduce compliance and legal costs associated with frivolous nexus claims.

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. 1083 to address this issue of the lack of uniformity in the standard for taxing an out-of-state business' 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.

PREPARED STATEMENT OF THE NATIONAL ASSOCIATION FOR THE SPECIALTY FOOD TRADE, INC. (NASFT)

STATE TAXATION – THE ROLE OF CONGRESS IN DEFINING NEXUS

STATEMENT OF
THE NATIONAL ASSOCIATION
FOR
THE SPECIALTY FOOD TRADE, INC.

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

February 4, 2010

The National Association for the Specialty Food Trade, Inc. (NASFT) is pleased that the Subcommittee on Administrative and Commercial Law is holding a hearing concerning state taxation, which often impacts in a significant way the ability and willingness of small businesses to sell in interstate commerce.

Specifically, the varying state interpretations and enforcement of "nexus" create uncertainty for small companies and so hinder the involvement of these companies in national commerce. The United States Supreme Court has not fully clarified the meaning of nexus, leaving uncertainty for businesses and multiple state interpretations. Congress can, and should, establish a uniform meaning of nexus. That ***is*** the role of Congress. NASFT supports a Congressional statement of the meaning of nexus and the approach of H.R. 1083, the Business Activity Tax Simplification Act of 2009.

Physical presence in a state is a crucial indicator of who should pay business activity taxes. 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.

Several NASFT members, which are small businesses, have paid thousands of dollars in assessments and back taxes rather than fight claims for the payment of state business activity taxes by states in which they had no presence and acted only through brokers (independent contractors). Some other NASFT members have spent precious time and resources trying to learn why they were being targeted and how to respond to the claims.

In considering the *Role of Congress in Defining Nexus*, the Subcommittee should be aware of the manner in which many small companies sell on the domestic market and how they grow. Most small food companies cannot afford a physical presence in states other than their home jurisdiction. When the business grows so that it is reasonable to sell outside the home territory, a small food company often reaches into the interstate market through the mail or through a broker in the other state.

The broker is a resident of the other state. It is an independent contractor - another independent small business – which sells the product lines of several companies and earns commissions. If the food manufacturer is successful, it does and should pay income taxes to its state authorities – in return for the safety, educational and other services that it receives. The broker pays taxes on its commissions to its state authorities – again in return for local services.

NASFT is concerned that, given the worsening financial situation of many states, more state tax authorities might be tempted to use an economic presence standard to capture tax revenue from out of state companies. While the situation of local jurisdictions might be deteriorating, small businesses also 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.

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. Of course it must be understood that most specialty food companies are well below $1 million in annual sales – they are very small businesses. 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.

Again, NASFT thanks the Subcommittee on Commercial and Administrative Law for addressing *State Taxation and the Role of Congress in Defining Nexus*. Defining nexus ***is*** the role of Congress.

PREPARED STATEMENT OF KATHRYN WYLDE, PRESIDENT & CEO, PARTNERSHIP FOR NEW YORK CITY

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Partnership for New York City

TESTIMONY SUBMITTED TO THE HOUSE JUDICIARY SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

HEARING ON STATE TAXATION: THE ROLE OF CONGRESS IN DEFINING NEXUS

Thursday, February 4, 2010

KATHRYN WYLDE
PRESIDENT & CEO
PARTNERSHIP FOR NEW YORK CITY

Thank you, Chairman Cohen and members of the Subcommittee for the opportunity to submit testimony.

The Partnership for New York City is a nonprofit organization representing leading international and regional business leaders who partner with government and organized labor to promote jobs, economic growth and public education. Our members are responsible for employing more than 7 million Americans and contribute $740 billion to the national Gross Domestic Product. We strongly support H.R.1083, the Business Activity Tax Simplification Act of 2009 ("BATSA").

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. With approaches to tax jurisdiction varying from state to state, clarifying the physical presence requirement to articulate the bright-line physical presence nexus standard included in H.R. 1083 would alleviate the burden that many interstate businesses face and help promote economic growth across the country.

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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., public schools, roads, police and fire protection, water and sewers). Businesses receive these benefits only from the jurisdictions where they are actually located. Businesses should only pay tax where they actually earn income, and economists agree that income is earned where a business employs its labor and capital.

BATSA would provide the clarity and discipline required to maintain a rational and hospitable business environment in the United States. It will also protect the tax base of America's major commercial centers that are absorbing the costs associated with the demands of major commercial operations.

Thank you for your consideration.

LETTER FROM EDWARD A. ZELINSKY, MORRIS AND ANNIE TRACHMAN PROFESSOR OF LAW, BENJAMIN N. CARDOZO SCHOOL OF LAW OF YESHIVA UNIVERSITY

Edward A. Zelinsky

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February , 2010

The Hon. Steve Cohen, Chairman
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
362 Ford House Office Building
Washington, D.C. 20515

Re: Nexus and the Telecommuter Tax Fairness Act of 2009

Dear Representative Cohen:

I appreciate the opportunity to submit this written testimony to your subcommittee in connection with its hearing on the role of Congress in defining nexus for state taxation purposes.
My testimony is straightforward: Congressionally-promulgated nexus standards are desirable and must be augmented by congressionally-established apportionment rules. In particular, I urge this subcommittee to support H.R. 2600, The Telecommuter Tax Fairness Act of 2009.

By way of background, I am the Morris and Annie Trachman Professor of Law at the Benjamin N. Cardozo School of Law of Yeshiva University.[1] State and local taxation is among the areas in which I teach and write. Among my research interests is the constitutional framework governing state and local taxation, in particular, the nexus and apportionment rules established under the Commerce and Due Process Clauses of the United States Constitution.[2] I was also the unsuccessful taxpayer in *Zelinsky v. Tax Appeals Tribunal*,[3] in which I challenged New York's

[1] This information is presented for identification purposes only. The testimony presented in this letter reflects my personal views. Neither Yeshiva University nor the Cardozo Law School has reviewed or approved this testimony.

[2] *See, e.g.*, Edward A. Zelinsky, *Rethinking Tax Nexus and Apportionment: Voice, Exit and the Dormant Commerce Clause*, 28 VA. TAX REV. 1 (2008).

[3] 1 N.Y.3d 85, cert. denied 541 U.S. 1009 (2004).

double income taxation of nonresident telecommuters under New York's so-called "convenience of the employer" doctrine. The Telecommuter Tax Fairness Act, if enacted into law, would overturn this and other decisions of the New York courts upholding the Empire State's double income taxation of nonresident telecommuters.

The dormant Commerce Clause decisions of the U.S. Supreme Court, such as *Scripto, Inc. v. Carson*[4] and *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue,*[5] hold that a person need have little physical presence in a state to create nexus for tax purposes between that state and such person. Thus, under existing law, many individuals and businesses with minimal physical presence in more than one state can be taxed in all of those states because in each state there is nexus - the minimum connection necessary for taxation - between the state and the individual or business the state seeks to tax.

To prevent multiple taxation, the U.S. Supreme Court has also imposed upon each state with nexus to an interstate actor the dormant Commerce Clause obligation to apportion as to that interstate actor. Under the rule of apportionment, each state with nexus to a person may tax only the state's respective share of that person's taxable activity.[6] Unfortunately, states with nexus (i.e., sufficient physical contact to tax) often flout their dormant Commerce Clause obligation to apportion. The result is multiple and overlapping taxation of individuals and businesses by each state with nexus to tax.

The problem is illustrated by my situation. I am typical of what we have come to call "telecommuters." I am a law professor who teaches in Manhattan. On days when I don't teach, I typically research and write at my home in New Haven, Connecticut. Thus, both Connecticut and New York have nexus to tax my income since I am physically present

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[4] 362 U.S. 207 (1960) (ten independent brokers representing a Georgia corporation in Florida create nexus in Florida for use tax purposes).

[5] 483 U.S. 232 (1987) (a single independent contractor in Washington State representing an out-of-state corporation creates nexus in Washington State for purposes of its business and occupation tax).

[6] MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16 (2008) ("The Commerce Clause forbids the States to levy taxes that discriminate against interstate commerce or that burden it by subjecting activities to multiple or unfairly apportioned taxation"); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977) (tax on interstate ommerce must be "fairly apportioned"); Central Greyhound Lines, Inc. v. Mealey, 334 U.S. 653, 663 (1948) (tax must be "fairly apportioned" between New York and other states).

in both states on different days.[7] On the days when I research and write at home, modern technology, e.g., email, cell phones, the internet, permits me to stay in touch with my colleagues and students in Manhattan (and other locations) even though I am at home in Connecticut.

That both New York and Connecticut have nexus to tax me and my teaching salary should not create a double tax problem under the Commerce Clause. By virtue of its obligation to apportion, New York should tax the part of my salary earned on the days I teach in Manhattan and am thus physically present in the Empire State. Correspondingly, by virtue of the rule of apportionment, Connecticut should tax the remainder of my salary earned on the days when I write and research at home and am thus physically present in the Nutmeg State.

Unfortunately, with the approbation of its courts, New York disregards its constitutional obligation to apportion and thus imposes its income tax on all of my academic salary, including the salary earned on the days I work at home in Connecticut. On those days, Connecticut provides me with public services such as police and fire protection and municipal water and sewage services. Nevertheless, New York, flouting its dormant Commerce Clause duty to apportion my salary for income tax purposes, uses its "convenience of the employer" rule to tax, not just the part of my salary I earn in New York, but the rest of my salary earned in Connecticut - even though Connecticut provides the public services I use on my days working at home. The result is double income taxation of the portion of my salary earned in and properly apportioned to Connecticut. In simplest terms, New York refuses to apportion, that is to say, New York insists on taxing all of my salary rather than the salary I earn within New York's borders.[8]

New York's double income taxation of nonresident telecommuters has not been limited to the New York tri-state area. Rather, New York has imposed its state income tax throughout the nation, on telecommuting individuals working in their homes as far away as Tennessee[9] and

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[7] Connecticut also has jurisdiction to tax my income by virtue of my residence in that state. Oklahoma Tax Commission v. Chickasaw Nation, 515 U.S. 450, 462-463 (1995) (authority of the states to tax their residents' incomes).

[8] For a more extended discussion of the constitutional and practical problems caused by the double taxation of nonresident telecommuters' incomes, *see* Edward A. Zelinsky, *New York's "Convenience of the Employer" Rule is Unconstitutional*," 48 STATE TAX NOTES 553 (2008).

[9] Huckaby v. New York State Division of Tax Appeals, Tax Appeals Tribunal, 4 N.Y.3d 427, cert. denied 546 U.S. 976 (2005).

Arizona.[10]

The U.S. Supreme Court has urged Congress to adopt nexus rules to replace the Court's dormant Commerce Clause case law.[11] That is an invitation Congress should accept. Only Congress can provide comprehensive statutory rules to replace the inherently intermittent nexus guidelines of the courts' dormant Commerce Clause case law.

Nevertheless, even if Congress enacts a federal nexus statute, that alone will not be enough. In a modern, integrated mobile economy, many businesses and individuals will simultaneously have nexus to multiple states, even if federal nexus standards are established legislatively. As my case (and those of countless other telecommuters) demonstrate, Congress must also enforce the apportionment principle so that all states with tax nexus to a particular interstate actor tax only their respective portions of the taxable activity of that actor. The alternative is multiple taxation of the same income (or other taxable base) by the various states with nexus to the same taxpayer.

For example, the Telecommuter Tax Fairness Act would require, in a case like mine, that New York apportion, that is to say, tax only the portion of my income earned on the days I am physically present in New York. The Act would thereby eliminate the double taxation caused by New York's "convenience of the employer" rule, a rule more properly labeled "the no-apportionment/double tax" rule.

I commend the subcommittee for holding this hearing on an important topic. Federal nexus legislation is desirable, indeed long overdue. However, such legislation, by itself, will not solve the problem of individuals and businesses being subject to multiple state taxation of their interstate activities. To truly solve this increasingly serious problem, Congress must also adopt federal rules of apportionment.

The Telecommuter Tax Fairness Act of 2009 would be a good place to start.

Sincerely,

Edward A. Zelinsky

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[10] In the Matter of the Petition of Manohar and Asha Kakar, DTA No. 820440 (February 16, 2006), 2006 STT 41-23.

[11] Quill Corp. v. North Dakota, 504 U.S. 298, 318 ("the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.")

LETTER FROM MATTHEW R. SHAY, PRESIDENT AND CEO,
THE INTERNATIONAL FRANCHISE ASSOCIATION (IFA)

February 4, 2010

The Honorable Steve Cohen
U.S. House of Representatives
House Committee on the Judiciary
Chairman, Subcommittee on Commercial and Administrative Law
362 Ford House Office Building
Washington, DC 20515

The Honorable Trent Franks
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: State Taxation – The Role of Congress in Defining Nexus

Dear Chairman Cohen and Ranking Member Franks:

The International Franchise Association (IFA) would like to thank you for convening this hearing on "State Taxation – The Role of Congress in Defining Nexus" and express strong support for the *Business Activity Tax Simplification Act* (BATSA) (H.R. 1083). BATSA would address 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. The IFA's mission is to safeguard the business environment for franchising worldwide. The association represents businesses in more than 85 industries, including more than 11,000 franchisee, 1,200 franchisor and 600 supplier members nationwide. According to a 2008 study conducted by PricewaterhouseCoopers, there are more than 900,000 franchised establishments in the U.S. that are responsible for creating 21 million American jobs and generating $2.3 trillion in economic output.

Why the Franchise Industry Supports BATSA:
While the United States Supreme Court, through its ruling in *Quill Corp. v. North Dakota*, justified the prohibition of states forcing out-of-state corporations to collect certain taxes unless it had established a physical presence in the taxing state, states have in recent years ignored the ruling and begun establishing an economic nexus standard for taxation. This has created tremendous hardships and confusion for businesses that use the franchise business

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model to expand their brand, while not necessarily the presence of their corporate entity, across 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 or her business and to inspect the franchisee's performance and furnish training advice and guidance, but the duration of such visits normally is limited to a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media.

Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on those states. Meanwhile, like any other enterprise domiciled in a state, a franchisee operating there would pay taxes, be involved in supporting community activities and create economic opportunities for employees and suppliers who would directly benefit from the existence of the enterprise.

Enactment of BATSA is important to the franchise 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.

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 and any state where is maintains physical presence) on the royalty income paid to the franchisor by franchisees located in a different state. Prior to the late 1980s, with rare exception, 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.

Franchise brands exist across a multitude of political boundaries in most franchise systems, but the franchisor is often a single entity with a clearly defined corporate residence. Some state revenue officials and, increasingly, legislators view the presence of a franchised outlet of a national or regional brand in their state, intentionally or not, as sufficient for the establishment of economic, rather than physical, nexus of the out-of-state franchisor. It has been incorrectly argued that the mere presence of intangible property in their jurisdiction satisfies the "substantial nexus" requirement under the Commerce Clause for the imposition of state income and related business activity taxes. Such arguments radically expand the classes of persons, relationships and transactions potentially subject to state income taxation, and threaten the livelihoods of hundreds of thousands of entrepreneurs who have chosen franchising as the route to small business ownership.

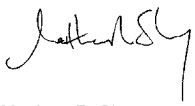
The issue has enormous implications for the businesses engaged in interstate franchising, a rapidly expanding part of the American economy. If permitted, such assessments would subject licensors of intangible property in interstate commerce to income taxation by every state in which goods or services 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.

If every state where a franchisor has granted franchises may tax its income attributable to that state, non-resident franchisors will be subject to costly compliance burdens and ever-escalating taxes. Under these circumstances, there is no doubt that franchisors will be forced to consider passing this cost of business on to their franchisees by increasing the royalty fees. Under this scenario the party most harmed is the resident franchisee. Thus, enactment of BATSA is critical for thousands of businesses, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Conclusion:
The IFA appreciates the efforts of the subcommittee in examining discrepancies in the application of nexus standards in state taxation. Unless addressed by Congress, 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 and hinder the growth of small businesses through franchising.

Thank you for considering this written testimony.

Sincerely,



Matthew R. Shay
President and CEO

LETTER FROM JOE HUDDLESTON, EXECUTIVE DIRECTOR,
MULTISTATE TAX COMMISSION (MTC)

MULTISTATE TAX COMMISSION

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Working Together Since 1967 to Preserve Federalism and Tax Fairness

February 10, 2010

The Honorable Steve Cohen, Chairman
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives
Washington, DC 20515-6216

The Honorable Trent Franks, Ranking Minority Member
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
U.S. House of Representatives
Washington, DC 20515-6216

Re: Hearing on State Taxation: The Role of Congress in Defining Nexus

Dear Congressmen Cohen and Franks:

I am writing on behalf of the Multistate Tax Commission to supplement the record in the February 4, 2010 hearing held by your Subcommittee.

More than forty years ago, several states working together developed and enacted the Multistate Tax Compact (Compact).[1] States' adoption of the Compact was critical to preserving the sovereignty the states enjoy with respect to taxation of interstate commerce. The Multistate Tax Commission (Commission) is the administrative agency for the Compact, which became effective in 1967. Today, forty-seven states and the District of Columbia are members of the Commission.[2]

[1] The Compact is designed to (1) facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes; (2) promote uniformity or compatibility in significant components of tax systems; (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and (4) avoid duplicative taxation.

[2] Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Maryland, New Jersey, and West Virginia. Associate Members: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Wisconsin, and Wyoming.

Professor Walter Hellerstein, Francis Shackelford Distinguished Professor in Taxation Law at the University of Georgia School of Law, testified that economic nexus is now the prevailing nexus standard in state tax law for corporate income taxes. He also testified that the physical presence standard, in this 21st Century world, "is becoming less important every day." The Commission certainly agrees that nexus for business taxes based on physical presence is a quaint notion that is laughable given the high-speed, fast-paced era of electronic commerce that we enjoy today.

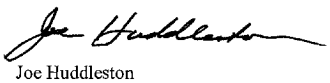
Because physical presence is virtually meaningless to the profits of large multistate and multinational corporations, those who advocate the adoption of H.R. 1083, the Business Activity Tax Simplification Act, are really advocating for their economic interests of at the expense of local, small businesses. Turning the clock back to the past century by imposing a physical presence standard for state business activity taxes even as our economy continues to operate and expand without regard to physical borders will put small, locally-oriented businesses at a clear competitive disadvantage to the large multistate and multinational corporations because they will be paying the state business activity taxes while the national companies will not. In effect, small businesses will be subsidizing the large multistate and multinational corporations in so far as funding state and local government is concerned. This will be especially true with community banks who will find it increasingly difficult to compete with interstate banks if the interstate banks offering the same services via mail and internet are not paying state corporate income taxes in marked contrast to the locally-oriented community banks.

All of the large multistate and multinational corporations represented by the organizations pushing for adoption of the Business Activity Tax Simplification Act would reap massive financial rewards at the expense of the small businesses located in your Congressional Districts and those of your colleagues on the Subcommittee.

Recognizing that interstate business taxpayers and the states which foster and preserve the markets these businesses engage should have a straightforward way to determine nexus for state tax purposes, the states of the Commission developed a common-sense approach to nexus commonly known as the "factor-presence nexus standard," a standard about which we'd be happy to provide you with more information. When Congress supports the states working together on interstate tax issues, positive things can happen, and the Commission stands ready, as in the past, to work with you on nexus issues.

Thank you for the opportunity to submit this information for your record.

Sincerely,



Joe Huddleston
Executive Director

PREPARED STATEMENT OF MARK LOUCHHEIM, PRESIDENT, BOBRICK WASHROOM EQUIPMENT, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Statement of
Mark Louchheim
President
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
State Taxation: The Role of Congress in Defining Nexus

February 4, 2010

Mr. Chairman 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 February 4, 2010, House Judiciary Subcommittee on Commercial and Administrative Law hearing on State Taxation: The Role of Congress in Defining Nexus.

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 Mark Louchheim and I have been President for the past 17 years of 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. 1083, the Business Activity Tax Simplification Act (BATSA) introduced in 2009 by House Judiciary Committee members Rick Boucher (D-VA) and Bob Goodlatte (R-VA). The full committee is urged to report favorably H.R. 1083 as soon as possible. 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 400 people, has subsidiaries in Australia and England. Bobrick manufactures more than 70 percent of its products in the United States and exports more than $20,000,000 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 29 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 appealed the Texas decision on nexus, an effort that cost us more than $185,000 for attorneys and consultants as well as a significant amount of internal staff time. Most recently, our company filed a "Claim for Refund of Sales and Use Tax" with the Texas Comptroller of Public Accounts. Texas rejected the claim and we are continuing to pursue our remedies as required by the Tax Injunction Act of 1937 (28 U.S.C. § 1341).

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

As soon as possible, the full committee should report favorably H.R. 1083, BATSA legislation. 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.

PREPARED STATEMENT OF THE ORGANIZATION FOR INTERNATIONAL INVESTMENT (OFII)

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

Organization for International Investment ("OFII")
Written Statement for the Record of the House Judiciary Commercial and Administrative Law Subcommittee Hearing on State Taxation – The Role of Congress in Defining Nexus

February 4, 2010

The Organization for International Investment ("OFII") appreciates the opportunity to comment on the role of Congress in defining "nexus" within state taxation. OFII urges the Committee to play an active role in resolving the issue of economic nexus in order to address a growing concern for international businesses – the increasing number of U.S. states that have been inappropriately aggressive in attempting to increase their share of the global tax base of multinational companies by expanding their fiscal jurisdiction outside the United States. Expansive interpretations of economic nexus by U.S. states threaten to impose significant double taxation on non-U.S. companies and make the United States a less competitive location for global businesses to invest and create jobs. The exterritorial taxation resulting from these interpretations is inconsistent with U.S. federal income tax laws, international norms of taxation and violates the spirit of U.S. double taxation treaties. Such tax treatment is fundamentally unfair and risks harmful and unnecessary disputes with our major trading partners.

OFII represents the U.S. operations of companies headquartered abroad, companies which directly employ over 5 million Americans across the 50 U.S. states. OFII promotes fair and equal treatment for these "Insourcing" companies in U.S. federal and state law. We undertake this mandate with the goal of making the U.S. an increasingly attractive market for international companies to invest and create American jobs. At a time when the U.S. Congress is considering ways of attracting new business investment, preserving fair and equitable tax treatment at the federal and state level is more critical than ever.

I. Insourcing Companies in the United States

As illustrated in the attached membership list, and by the facts below, "insourcing" companies, play a major role in our nation's economy, providing critically important jobs (and the associated tax base) in communities across the country.

Some salient facts about insourcing companies:

- U.S. subsidiaries employ 5.5 million Americans — 4.6% of total U.S. private sector employment;
- U.S. subsidiaries account for 6% of total U.S. GDP;

- U.S. subsidiaries support an annual payroll of $403.6 billion — with average compensation per worker of $73,124, which is 34.7 percent higher than compensation at all U.S. companies;
- U.S. subsidiaries heavily invest in the American manufacturing sector; with 29 percent of the jobs at U.S. subsidiaries in manufacturing industries;
- U.S. subsidiaries manufacture in America to export goods around the world — accounting for nearly 18.5 percent of all U.S. exports, or $215.6 billion;
- U.S. subsidiaries pay over 14 % of U.S. federal corporate taxes, according to the IRS, a larger share than their relative size in the U.S. economy.
- U.S. subsidiaries have a larger percentage of workers covered by a union collective-bargaining agreement than other U.S. companies — 12.4% of employees at U.S. subsidiaries compared to just 8.2% at other U.S. firms.

II. Extraterritorial State Taxation Risks Economic Benefits

The significant contributions insourcing companies bring to the U.S. economy are a direct result of the U.S.'s open investment environment, which treats these companies and the Americans they employ on a level playing field with their domestic competitors. The growing trend of U.S. states moving to extraterritorial taxation of non-U.S. companies undermines these contributions.

- U.S. states' aggressive fiscal behavior: (1) can deter foreign investment in the U.S. due to increased uncertainty for double taxation; (2) disrupts the international tax treaty network; (3) could encourage retaliatory foreign legislation; and (4) creates uncertainty, complexity, inadministrability and substantial costs.

- It is important that the U.S. government maintain its ability to speak with one voice on international fiscal matters and not be undermined by the efforts of individual states.

- States have other tools to combat perceived fiscal abuse. Current state actions are inappropriately sweeping in legitimate business transactions.

- When U.S. states have taken extraterritorial tax actions in the past, many U.S. treaty partners have issued strong objections and even adopted blocking statutes and laws mirroring this inappropriate tax treatment for U.S. multinationals.

U.S. states are expanding their fiscal reach in two different ways: (1) "economic nexus"; and, (2) expanded "water's edge" provisions.

1) Economic Nexus

U.S. double taxation treaties require a physical presence (usually defined as property, employees, etc.) in Country A before Country A can levy an income tax on a company incorporated in Country B. However, since U.S. states are NOT bound by U.S.

tax treaties, some have adopted "economic nexus" provisions that impact foreign parents and affiliates incorporated in other countries.

Specifically, approximately 25 U.S. states have already adopted an expansive "economic nexus" theory, which does **NOT** require physical presence to assert taxing authority (see attached map).

For instance, a company incorporated in the U.K., with no physical presence or employees in the U.S., may find itself subject to tax in a particular U.S. state.

Example: Recently, New Jersey has sent tax assessments directly to certain foreign parents of U.S. subsidiaries under an "economic nexus" theory. New Jersey authorities claim they have a right to tax these foreign companies merely because they have received royalty payments from U.S. affiliates doing business in New Jersey. The foreign parent companies have NO physical presence in New Jersey. The international business community has been extremely active in fighting this effort. There has been no resolution to date.

"Economic nexus" provisions were originally developed to deter U.S. companies from directing intangible revenue to domestic affiliates located in states that do not tax this income, thus reducing their overall tax burden. However, U.S. states have other provisions to effectively combat such abuses and the use of a broad "economic nexus" theory unfortunately sweeps in legitimate business transactions.

2) <u>Expanded "Water's Edge"</u>

Some U.S. states have taken the position that **all** foreign affiliates of a company doing business in a state should be included in a "combined return," **regardless** of whether such foreign affiliates have physical presence or nexus in that state. However, most states with "combined reporting" allow companies with affiliates in other countries to make a "water's edge" election. Under a "water's edge" election, the combined group – i.e., the companies that are taxable in the state - is comprised only of those affiliated corporations within the "water's edge" of the United States (the 50 states and the District of Columbia).

Various U.S. states are now expanding the definition of "water's edge" beyond the Atlantic and Pacific Oceans. Specifically, foreign affiliates that earn a certain percentage of income from U.S. sources are being deemed part of a state's "combined group" for tax purposes - even if the U.S. federal government does not subject such foreign affiliate to income taxes.

Example: Effective beginning in 2009, Massachusetts enacted a Combined Reporting Statute that includes an expanded definition of a "water's edge" election. Specifically, the "water's edge" group would include foreign companies that receive more than 20% of their income from a U.S. source. Importantly, these foreign companies have no physical presence or nexus in the U.S. Therefore,

foreign companies that are already subject to tax in their home country and that are not subject to federal income taxes would be required to file a Massachusetts tax return and pay tax in Massachusetts. The international business community is currently embroiled in an effort to change the law, with no resolution to date.

Acting on an expanded "water's edge" approach in the 1990s, California attempted to bring foreign affiliates of U.S. companies into its tax base even though they had no physical presence in the U.S and were subject to tax in their home countries. This proposal drew strong objections from U.S subsidiaries of foreign companies and from U.S. treaty partners who rightly viewed California's proposal as a revenue grab, and an erosion of treaty protections for its corporate citizens. Many countries raised serious concerns about California's efforts and the U.K enacted retaliatory legislation against California-based companies. As a result, California dropped its extraterritorial aspirations and adopted a "water's edge" election whereby a U.S. combined group could elect to limit such group to affiliates with physical presence or nexus in the U.S.

CONCLUSION

As stated above, a growing number of U.S. states have adopted aggressive "economic nexus" theories and expanded "water's edge" statutes that increase the risk factor of double taxation for foreign parents and affiliates of U.S. subsidiaries. Although U.S. double taxation treaties are meant to offset these risks, U.S. states are NOT bound by the treaties. As a result, foreign companies that have no U.S. physical presence and are not subject to federal income taxes may find themselves subject to double taxation by their home country and U.S. states. This creates an unlevel playing field since nearly all U.S. double taxation treaties bind the non-U.S. treaty partners' sub-national governments, such as cantons, provinces and states.

Moreover, this approach enables states to conduct their own individual foreign fiscal policies at the detriment of investment flows into the U.S., endangering and disrupting the treaty network, and violating the international norms respecting national fiscal jurisdictions. There is no U.S. Constitutional prohibition that would prevent the U.S. federal government from including the states in the treaties, only a potential political issue. It is important that the U.S. government maintain its ability to speak with one voice and not be undermined by the efforts of individual states.

The potential for damage from this aggressive approach is significant. Current economic conditions are provoking U.S. states to expand their fiscal jurisdictions beyond U.S. borders with overly broad legislation. It is extremely important for the U.S. Congress to address this aggressive behavior.

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

OFII is the only business association in Washington D.C. that exclusively represents U.S. subsidiaries of foreign companies and advocates for their non-discriminatory treatment under state and federal law.

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Zurich Insurance Group

PREPARED STATEMENT OF CAREY J. "BO" HORNE, PAST PRESIDENT, AND KATHERINE S. HORNE, PAST VICE PRESIDENT, PROHELP SYSTEMS, INC.

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. 1083

"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

February 4, 2010

Small Businesses Face an Impossible Situation

Small businesses have always faced great challenges. Today, we confront the greatest ever. Caught in the middle of an enormous struggle between large businesses and greedy states over highly complicated tax nexus issues, small businesses are left in an **impossible** position. The ability of our smallest businesses to participate in Interstate Commerce, on any basis, is **literally** at stake.

Highly aggressive, quickly expanding, and even abusive tax nexus claims made by **many** states amount to nothing short of legalized extortion. Except such claims are of dubious Constitutionality. The Supreme Court has said de minimis activity is insufficient for creating nexus. But, because such activity has not been adequately quantified into Federal law by Congress or by the Courts, the states are using every contrivance possible to defy past decisions which are very clear to the average citizen.

The result is now leading our Nation quickly toward the very scenario which compelled our Founders to include the Commerce Clause in our Constitution. Just as occurred under the Articles of Confederation, greedy, revenue-hungry states are today seriously harming our Nation's economy. Our own personal experience clearly illustrates how real the problem is and how terribly extreme state nexus laws have become. No entrepreneur who sufficiently understands the nexus risks facing the smallest businesses today will ***ever*** contemplate launching a new business that depends on making interstate sales of any type or size.

The Supreme Court has declined to become further involved in this issue. Only strong action by the Congress can now prevent major damage to our fragile economy and avert the ***complete closure of interstate markets to our Nation's smallest businesses. We are not the only small business which has experienced this issue. We are not even the only South Carolina small business which has been horribly burdened by it.***

Our Nation's smallest businesses cannot possibly cope with the widely varying, ever changing, and often poorly articulated nexus laws of 50 States and more than 12,000 local taxing authorities. It is unbelievable, but true, that it is today safer for small businesses to accept orders from customers in Canada than it is to accept orders from customers in other States.

We urgently ask for your support, markup, report, and quick passage of HR-1083, The Business Activity Tax Simplification Act of 2009, before the problem grows even worse, more small businesses attempting to participate in Interstate Commerce are harmed, and further damage is inflicted upon our fragile economy.

Similarly, our smallest businesses **must be carefully and fully protected** in any legislation which arises from the Streamlined Sales Tax now being considered. Even a simplified and streamlined process will create horrible administrative and compliance burdens, exactly like those already caused by Business Activity Taxes.

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 further 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, though, the states simply ignore the **total impossibility** for any small business to:

- Become familiar with the widely varying and ever changing nexus and tax laws of 50 States, let alone comply with them. How will mom and pop businesses **ever** be able to comply?
- Deal with the staggering burden of 12,000 differing nexus laws and business activity taxes authorized by the states for their localities. How can **any** small business handle such magnitude?
- Cope with the staggering variety of minor yet very common business activities, shown on page 7, 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 **insurmonntable** 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:

Some small businesses are not yet vocal with their support for the Business Activity Tax Simplification Act ("BATSA", HR-1083). 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, aud 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.

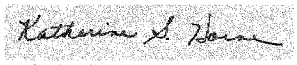
Only a **strong** restatement of the fundamental principles of physical presence will resolve the tragic and **impossible** consequences small businesses are facing. These principles worked so well for more than 200 years that they were simply "understood" and not even codified into law until the Congress 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]
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Seneca, SC 29672

[1] Testimony and complete transcript of the hearing with Mr. Delahunt's comments were previously 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 8.

[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 Admiuistrative 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 wonld 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 **fnture** 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 nntil small business is given the protection it mnst have in order to participate in Interstate Commerce on a free and nnhindered 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 distributiou of taxable iucome 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.

PREPARED STATEMENT OF THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS (USCIB)

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

Comments of the United States Council for International Business
Before the House Judiciary Committee
Subcommittee on Commercial and Administrative Law
Hearing on "State Taxation: The Role of Congress in Defining Nexus"
February 4, 2010

The United States Council for International Business (USCIB) promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing the International Chamber of Commerce, the International Organization of Employers and the Business and Industry Advisory Committee to the OECD, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

USCIB applauds the Subcommittee on Commercial and Administrative Law for its attention to the important issue of the nexus rules applicable to state taxation of the income of nonresident businesses. We strongly support the Business Activity Tax Simplification Act of 2009 ("BATSA"), H.R. 1083, and respectfully urge the House Judiciary Committee to act quickly to favorably report that legislation to the full House.

BATSA, introduced by Reps. Rick Boucher (D-VA) and Bob Goodlatte (R-VA), has strong bipartisan support among members of the House Judiciary Committee. The bill would clarify that the constitutional nexus standard applicable to state assessment of income and other direct taxes on business is physical presence. The bill also articulates a bright-line physical presence standard that is fair, predictable and consistent.

All tax treaties to which the United States is party include a provision that prevents parties to those treaties from imposing any direct tax on a nonresident business unless the taxpayer has a "permanent establishment" in the taxing country.[1] "Permanent establishment" is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on"—in other words, a physical presence nexus standard.

[1] Like most other countries, the United States generally follows the OECD's Bilateral Model Tax Treaty as a model to ensure that taxpayers have a level playing field and a bright-line test for taxation. Pursuant to that model treaty, before a country can impose a tax on a nonresident, such person must have a "permanent establishment" there, which is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." *See* OECD Model Tax Convention on Income and on Capital, Articles 5, 7.

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

Not only is BATSA's physical presence nexus standard consistent with the permanent establishment standard, it actually sets a much lower threshold for the requisite physical presence required before a state can impose a direct tax on an out-of-state business. Moreover, BATSA's physical presence nexus standard accomplishes the same policy goals as the country's tax treaties.

If BATSA is not enacted into law, the states will be able to undermine the country's international tax treaties by using economic nexus theories to tax the income of international businesses that do not have any physical presence in that state (and which are not subject to federal income taxation). Such actions by the states would severely undermine the country's negotiating position with foreign nations and invite reciprocal tactics by foreign nations against U.S. companies doing business abroad. All of this would seriously compromise the competitive leadership of U.S. businesses.

The differences between an economic nexus standard for state level business activity taxes and a permanent establishment standard for federal income taxes lead to anomalous results for foreign companies doing business in the United States. For instance, a foreign firm with no permanent establishment in the United States whose contacts with a state rise to the level of economic nexus could be exposed to state-level taxes on its business activity. But, because it has no permanent establishment, it would be protected by the treaty from imposition of federal income taxes. Adoption of a uniform standard that requires some level of physical presence for state taxes would provide some semblance of parity between the two tax regimes.

We appreciate the opportunity to offer this testimony before the Subcommittee, and we look forward to working with the House Judiciary Committee, and with members of the Commercial and Administrative Law Subcommittee, to enact BATSA.

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Global Business Leadership as the U.S. Affiliate of:
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International Organization of Employers (IOE)
Business and Industry Advisory Committee (BIAC) to the OECD
ATA Carnet System

Prepared Statement of

American Trucking Associations

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

February 4, 2010

Hearing on H.R. 1083

The Business Activity
Tax Simplification Act of 2009

Mr. Chairman, Ranking Member Franks, and members of the Committee:

Interstate commerce depends very heavily on efficient freight transportation. Most of that freight is carried by truck – some 69% by tonnage and some 83% 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. 1083, the Business Activities Tax Simplification Act of 2010, 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.

[1] Some 88% of motor carriers operate fewer than seven trucks; less than 4% operate more than twenty. American Trucking Assns., *2009-2010 American Trucking Trends*, ATA: Arlington, VA, 2010, pp. v-vi.
[2] ATA is the national trade association of the American trucking industry. It is a united federation of motor carriers, state trucking associations, and national trucking conferences created to promote and protect the interests of the motor carrier industry. ATA's membership includes 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.

The years 2008 and 2009 have been extraordinarily bad years for trucking. The deregulated industry has never faced times like these. Truck tonnage is down very substantially at the current time, the number of loads hauled is likewise down, and carriers' revenue per load is down most of all. The current year is not expected to see a return to business as usual for motor carriers.

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

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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., *2009-2010 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

has but one place of business – in its home state – and has no property or payroll in any other jurisdiction.[9]

Held for Ransom

Imagine now if you will the situation of a small trucking company, one that might be based in any state and operates only a few trucks. In the course of its business, it gets a call to pick up or to deliver a load in New Jersey, a state it may enter only occasionally. In New Jersey, perhaps at a rest stop or a shipper or consignee's loading dock, an agent of the New Jersey Division of Taxation approaches the truck, identifies himself to the driver, states that the company hasn't registered for the state's corporate tax, and asks the driver how long the company has been picking up or delivering loads in New Jersey. The driver is unlikely to know, of course, but will probably venture some number of years. The state multiplies the number given by $1,100, and the resulting sum serves as a "jeopardy assessment" of corporate tax – in practical effect the ransom for the truck, the driver, and its cargo. The truck and cargo is impounded, the driver is told to contact the company and that the truck will be released only when the money is wired to the state. If the driver protests at the outrage, he may be taken to jail. *There is evidence that New Jersey has 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

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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.

[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. In times like these, a jeopardy tax assessment such as those New Jersey has been in the habit of levying on the industry could easily be the last straw for a company attempting to stave off bankruptcy.

[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.

determined that they have nexus there and enclosing a bill, typically for several years (occasionally even decades) of back taxes, plus penalty and interest.

Particularly for smaller motor carriers, this is a cruel absurdity. Typically, the state that seeks to force interstate motor carriers to pay its business taxes not only assesses for years of back taxes, but also either imposes a minimum corporate tax or taxes gross rather than net receipts.[12] Through the use of these gimmicks, a state will have magnified the claimed liability out of all proportion either to the carrier's travel in the state or to its net income.

A large, unanticipated assessment for back taxes frequently represents a disaster for a small (or even a larger) motor carrier. For the more distant back years, the carrier will also be precluded by the statute of limitations from amending the returns it filed with its home state and claiming a credit. Last – and definitely not least – are the accountant's fees the carrier must pay to have the newly required return prepared. These can run upwards of $1,500 for even a relatively simple corporate tax report. And this is an expense the carrier can look forward to bearing in each year into the future, for once it starts filing an annual tax return with a state it cannot easily stop doing so.

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-

[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,

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.

State Retaliation

The year 2009 saw something new in this difficult area – an instance of one state threatening to retaliate against another because of the latter's aggressive pursuit of business taxes motor carriers based in the former. Colorado Joint Resolution HJR09-1024, adopted May 6, 2009, and attached to this testimony, first recites the elements of the problem we are addressing here, and then encourages the Colorado Department of Revenue to increase its enforcement of Colorado business taxes against carriers based in states that have "unreasonably" burdened Colorado's. In somewhat similar fashion, South Dakota Senate Concurrent Resolution 7, adopted March 9, 2009, and also attached to this testimony, calls on the state of Nebraska to "provide tax relief and amnesty" to trucking companies based in South Dakota. The situations these resolutions seek to address are serious, but it may be evident that state efforts of this sort could easily make things worse rather than better for interstate motor carriers. A federal solution is needed. The current economic times only make this more urgent.

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

Consolidated Freightways Corp. of Delaware v. Wisconsin Dept. of Revenue, 477 N.W.2d 44 (Wisc., 1991).

ATTACHMENT 1

First Regular Session
Sixty-seventh General Assembly
STATE OF COLORADO

REVISED

LLS NO. R09-1055.01 John Kilgour **HJR09-1024**

HOUSE SPONSORSHIP

Sonnenberg,

SENATE SPONSORSHIP

Hodge,

House Committees	**Senate Committees**
Transportation & Energy	

HOUSE JOINT RESOLUTION 09-1024

CONCERNING THE ACTIONS OF OTHER STATES IN SUBJECTING COLORADO-BASED INTERSTATE MOTOR CARRIERS TO AN UNREASONABLE INCOME TAX.

WHEREAS, Colorado's interstate motor carrier industry is an essential component of this state's economy; and

WHEREAS, Colorado's interstate motor carrier industry is made up overwhelmingly of small businesses; and

WHEREAS, For the past several years, certain other states have been seeking to subject Colorado-based interstate motor carriers operating in those states to the unreasonable enforcement and collection of state income tax, although such carriers have no permanent real property, assets, or employees in those states; and

WHEREAS, The collection of such taxes by other states involves a recent shift in income tax enforcement by those states, and some of them have sought many years of back taxes from interstate motor carriers

SENATE
FinalReading
May 6, 2009

HOUSE
FinalReading
April 29, 2009

Shading denotes HOUSE amendment. Double underlining denotes SENATE amendment.
Capital letters indicate new material to be added to existing statute.
Dashes through the words indicate deletions from existing statute.

based in Colorado; and

WHEREAS, The burden of such unwarranted tax collection and the heavy associated compliance costs are particularly significant for Colorado motor carriers in this time of economic distress; now, therefore,

Be It Resolved by the House of Representatives of the Sixty-seventh General Assembly of the State of Colorado, the Senate concurring herein:

That, should other states continue to subject Colorado-based interstate motor carriers to such unreasonable tax collection, the General Assembly hereby encourages the Colorado Department of Revenue to increase its enforcement of Colorado income tax law as it relates to interstate motor carriers based in other states who conduct a portion of their business in Colorado, and thereby enhance its collection of income taxes from such carriers.

Be It Further Resolved, That copies of this Joint Resolution be sent to Governor Bill Ritter, Jr., Executive Director of the Colorado Department of Revenue Roxy Huber, and the Board of Directors of the Western Governors' Association.

ATTACHMENT 2

SENATE CONCURRENT RESOLUTION NO. 7

A CONCURRENT RESOLUTION, Requesting the State of Nebraska to provide tax relief and amnesty for certain South Dakota trucking companies.

WHEREAS, the State of Nebraska has recently notified many South Dakota trucking companies that they are required to file Nebraska state income tax returns; and

WHEREAS, the State of Nebraska has a state income tax which applies to the trucking industry and is administered by special trucking rules. The Department of Revenue from the State of Nebraska has contacted many South Dakota trucking companies to ascertain their potential income tax obligation to the State of Nebraska. These companies were unaware of their income tax obligation to the State of Nebraska; and

WHEREAS, the actual taxable revenue is apportioned to Nebraska for those loads that are loaded and unloaded in Nebraska. Otherwise, apportionment is based on all the miles traveled in Nebraska divided by the overall miles traveled by the trucking company; and

WHEREAS, the South Dakota trucking companies did not anticipate that they could incur a Nebraska income tax obligation for miles traveled in Nebraska when the load was either loaded or unloaded within the boundaries of another state or country; and

WHEREAS, economic times have been extremely difficult for many industries and individuals as well as governmental units, especially state governments. It is understandable in these difficult times, that states look for every source of revenue; and

WHEREAS, the State of Nebraska and the State of South Dakota have each agreed to a tax amnesty policy regarding other forms of taxation. For example, the Streamlined Sales Tax Project amnesty program is an attempt to have potential tax payers report and pay their current and future tax obligations in a timely manner without worry of substantial penalty; and

WHEREAS, South Dakota trucking companies are now better informed of their income tax obligation to the State of Nebraska and the rules that administer and apply that income tax:

NOW, THEREFORE, BE IT RESOLVED, by the Senate of the Eighty-fourth Legislature of the State of South Dakota, the House of Representatives concurring therein, that the South Dakota Legislature requests the Nebraska Legislature to forgive all or part of the income tax due for past

years on South Dakota trucking companies and to apply this tax on current and future income. Favorable resolution of this matter by the Nebraska Legislature will provide relief to an industry that also faces financial struggles; and

BE IT FURTHER RESOLVED, that the South Dakota Legislature requests the Nebraska Legislature to develop an amnesty program for out-of-state trucking companies. The amnesty program will encourage the trucking companies to file income tax returns and pay their tax obligations in a timely manner without fear of severe penalties and interest; and

BE IT FURTHER RESOLVED, that the South Dakota Legislature expresses its appreciation for the Nebraska Legislature's consideration of this matter.

Adopted by the Senate, March 5, 2009
Concurred in by the House of Representatives, March 9, 2009

Dennis Daugaard President of the Senate	Trudy Evenstad Secretary of the Senate
Timothy A. Rave Speaker of the House	Karen Gerdes Chief Clerk of the House

LAW REVIW ARTICLE SUBMITTED BY MARJORIE B. GELL, ASSISTANT PROFESSOR,
THE THOMAS M. COOLEY LAW SCHOOL

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

BROKEN SILENCE: CONGRESSIONAL INACTION, JUDICIAL REACTION, AND THE NEED FOR A FEDERALLY MANDATED PHYSICAL PRESENCE STANDARD FOR STATE BUSINESS ACTIVITY TAXES

Marjorie Gell[*]

In all ages and climes those who are settled in strategic localities have made the moving world pay dearly. This the commerce clause was designed to end in the United States.[i]

I. INTRODUCTION

The development of a global economy, massive changes in technology and a shift from a goods-based to a service-based economy, have all brought unprecedented changes in the flow of U.S. commerce. With its status as the clear-cut leader of the economic world in peril, the United States is currently facing increasing competition for the sale of its goods and services from countries such as China and India. How the United States ultimately reacts to this increasing competition, and the extent to which the United States can successfully adapt to a changing world, will determine what the long term economic outcome will be for the U.S. economy.

At the core of this country's collective economic strategy, just as it was at the time the U.S. Constitution was ratified, is the need for strong and united national market. This principle is found in the Commerce Clause of the U.S.

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[*] Assistant Professor, Thomas M. Cooley Law School, Grand Rapids, Michigan.
[1] Northwest Airlines v. Minnesota, 322 U.S. 292, 307 (U.S. 1944) at 307 (concurring opinion).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

Constitution and has been the foundation of this country's economy for almost two and a quarter centuries. Yet, as important as a strong economic union is to the fiscal health of this country, the unifying principle embodied in the Commerce Clause has been eroded over the last 50 years by the conflicting and burdensome tax policies of individual states. Of particular harm has been the unfettered assertion by states of business activity tax[2] jurisdiction over out-of-state companies with little or no in-state physical presence.

The purpose of this article is twofold: first, to explore the proper role of Congress in exercising its commerce power to regulate state tax jurisdictional standards for business activity taxes; and second, to evaluate the need for a federally mandated physical presence standard with regard to such taxes. Part II discusses the constitutional framework of the Commerce Clause, the policies underlying it, and its application to state business activity taxes. As well, it will look at the Supreme Court's calls for Congress to exercise generally its affirmative grant of powers under the Commerce Clause. Part III will review Congressional obligations to address inconsistent jurisdictional nexus standards under the Commerce Clause. It will also discuss

[2] Business activity taxes are direct taxes imposed on the profits, income, gross receipts or capital stock value of a business taxpayer. Examples are corporate income, franchise, gross receipts or capital stock taxes. These are distinguished from indirect taxes such as sales and use taxes. *See* ABA Tax Section, *Draft White Paper on Business Activity Taxes and Nexus*, n. 2 (February 26, 2008).

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enactment of Public Law 86-272 ("P.L. 86-272"), the temporary measure adopted by Congress in 1959 in response to *Northwestern States Portland Cement Co. v. Minnesota*,[3] a Supreme Court decision that allowed imposition of a state income tax on interstate commerce. Part IV will discuss Congress' post-P.L. 86-272 silence regarding fundamental state tax taxation rules, and the corresponding judicial responses to irreconcilable standards by which states impose business activity taxes. In particular, Supreme Court cases will be reviewed, both before and after enactment of P.L. 86-272, with respect to the interpretation of the Commerce Clause in resolving state tax jurisdictional issues. The centerpiece of this discussion will be the seminal Supreme Court case of *Quill v. North Dakota*,[4] and the extension of the principles of that case to state business activity taxes.

Part V will examine recently introduced federal legislation that would bring clarity to the issue of state business activity tax jurisdiction, and would encourage the development of an economic "united front." This legislation, the Business Activity Tax Simplification Act of 2007 the Business Activity Tax Simplification Act of 2008 (hereinafter

[3] 358 U.S. 450 (1959).
[4] 504 U.S. 298 (1992).

referred to as "BATSA"),[5] proposes the enactment of a physical presence standard that would apply to all state business activity taxes. The discussion here will center on the necessity of a physical presence standard, and will consider various alternatives to the physical presence standard including one recently suggested to Congress in a report submitted by the Tax Section of the New York State Bar Association ("New York Tax Section").[6] Arguments will be made as to why 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. Finally, Part VI will conclude that it is incumbent upon Congress to exercise its powers given to it by our Founding Fathers to enact a clear and decisive physical presence standard upon which companies in interstate commerce can rely in determining their state tax exposure and liabilities, and to once and for all end the ages-old controversy of jurisdictional thresholds for state taxation under the Commerce Clause.

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[5] 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.

[6] Its report entitled *Nexus Requirements for Imposition of Business Activity Taxes* (January 25, 2008) (hereinafter referred to as the "New York Tax Section Report") recommends the adoption of a "hybrid" nexus standard consisting of both a physical and economic presence standard. *See* <http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=13360>.

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II. BACKGROUND

A. The Commerce Clause: Limitations and Policies

Under the Commerce Clause, Congress has the explicit power to "regulate Commerce with foreign Nations, and among the several States."[7] Alexander Hamilton, a staunch nationalist, wrote in the Federalist Papers about the underlying purposes of the Commerce Clause and the importance of a free and open market:

> An unrestrained intercourse between the States themselves will advance the trade of each by an interchange of their respective productions, not only for the supply of reciprocal wants at home, but for exportation to foreign markets. The veins of commerce in every part will be replenished and will acquire additional motion and vigor from a free circulation of the commodities of every part. Commercial enterprise will have much greater scope from the diversity in the productions of different States.[8]

The original purpose of the Commerce Clause, then, was to give Congress the power to protect the national economic market by preventing barriers to the free flow of commerce, such as those barriers created by conflicting and burdensome state legislation. The need for such power arose in the 1790s when states began enacting protectionist taxes and regulations in acts of "economic warfare," that were in part a reaction to the loss of colonial subsidies and preferences previously granted by

[7] U.S. Const. art. I, 8, cl. 3.
[8] FEDERALIST NO. 11 (Alexander Hamilton).

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England."[9] At the time, under the Articles of the Confederation, Congress was rendered useless, particularly in the face of states that were exercising their respective taxing powers without regard to how such regulations affected the national economy. It was precisely because of the unwillingness of states to concede some of their taxing powers in the name of a unified national economy, that the Framers of the Constitution drafted the Commerce Clause giving Congress the power to intercede when and where appropriate in matters of interstate commerce. Had states been capable of acting altruistically on their own, had they been able to make individual concessions to promote a national marketplace, the Commerce Clause would have been wholly unnecessary.

The extent of Congressional power to exercise the Commerce Clause was made clear in 1824 when the Supreme Court in *Gibbons v. Ogden* stated that Congressional power under the Commerce Clause "is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the constitution."[10]

Despite the clear pronouncement of Congress's authority under the Commerce Clause, Congress has rarely chosen - mostly notably in 1959 - to exercise this power in any meaningful way

[9] Grant S. Nelson & Robert J. Pushaw, Jr., *Rethinking the Commerce Clause: Applying First Principles to Uphold Federal Commercial Regulations but Preserve State Control Over Social Issues*, 85 Iowa L. Rev. 1, 21 (1999).
[10] 22 US (9 Wheat.) 1 (1824).

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with respect to conflicting fundamental state tax policies. And, it has not enacted any statutes giving courts sufficient guidance as to how the courts should reconcile such conflicts. Rather, the responsibility has fallen solely on the shoulders of the courts for deciding whether the lines have been crossed with respect to the erection of state barriers that impede the free flow of commerce.

B. The Supreme Court's Reluctance to Exercise its Powers under the Negative Commerce Clause in Area of State Taxation

The authority by which the courts have developed standards of state taxation of interstate commerce comes from the "negative" aspect of the commerce clause.[11] Under this doctrine, where Congress has not exercised its affirmative grant of power under the Commerce Clause, states are nonetheless "negatively" restricted in their ability to tax or regulate interstate commerce.[12] As a corollary to this doctrine, where Congress has not exercised its power to protect interstate commerce, courts are left with the responsibility of balancing the need for a united, national economy, with the needs of states for sources of revenues. As the Supreme Court noted in *Southern Pacific Co. v. Arizona*:

[11] See Robert A. Sedler, *The Negative Commerce Clause as a Restriction on State Regulation and Taxation: An Analysis in Terms of Constitutional Structure*, 31 Wayne L. Rev. 885 (1985).
[12] *Id.* at footnote 1. This doctrine was first enunciated in Cooley v. Board of Wardens, 53 U.S. (12 How.) 299 (1851).

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> For a hundred years it has been accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation, thus affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests.[13]

The Court's application of the "dormant" Commerce Clause to a state's authority to tax interstate commerce has been a tortuous path, and the Court has long struggled - given the absence of any clear or meaningful guidance from Congress - with how to define interstate commerce, and to discern what limitations on state taxation should be imposed.[14]

The Court has often recognized the inappropriateness and inadequacy of the judicial branch in making inevitable national policy decisions in order to resolve jurisdictional issues of state taxation of interstate commerce. For example, in *McCarroll v. Dixie Lines, Inc.*, a 1940 case that struck down as violative of the commerce clause an Arkansas gasoline tax on out-of-state buses, Justices Black, Frankfurter and Douglas in their dissenting opinion made the following observation on the need for Congressional intervention in matters of state taxation of interstate commerce:

> This case again illustrates the wisdom of the Founders in placing interstate commerce under the

[13] 325 U.S. 761, 769 (1945).

[14] For a review of the historical development of the Supreme Court's approaches to state taxation in the context of the Commerce Clause, see Jerome R. Hellerstein & Walter Hellerstein, STATE TAXATION, 4.06.

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> protection of Congress. . . The present problem is not limited to Arkansas, but is of national moment. Maintenance of open channels of trade between the States was not only of paramount importance when our Constitution was framed; it remains today a complex problem calling for national vigilance and regulation.[15]

The same sentiments were expressed in 1944 in *Northwest Airlines v. Minnesota*.[16] The issue there was whether either the Commerce Clause or the Due Process Clause of the Fourteenth Amendment barred Minnesota from enforcing its personal property tax imposed on a fleet of airplanes that operated in interstate transportation. Justice Frankfurter, upholding the tax, made clear that "the dangers of harassing state taxation affecting national transportation" were concerns for Congress, and not the judiciary.[17] Justice Black, in his concurring opinion, stated that

[15] 309 U.S. 176, 188-89 (1940) (dissenting opinion). The struggles with the scope and application of the dormant commerce clause are also found in non-tax cases. For instance, two years prior to *McCarroll v. Dixie Lines, Inc.*, the Supreme Court in *South Carolina State Highway Dep't v. Barnwell Bros., Inc.* declined to invalidate a state law prohibiting use of highways by trucks over 90 inches wide or 20,000 pounds at a time when virtually all trucks used in interstate commerce exceeded these limits. The Court acknowledged that the state law had a negative effect in interstate commerce but pointed out that it was for Congress - not the judiciary – to decide whether the burdens of interstate commerce justified action:

> Congress, in the exercise of its plenary power to regulate interstate commerce, may determine whether the burdens imposed on it by state regulation, otherwise permissible, are too great, and may, by legislation designed to secure uniformity or in other respects to protect the national interest in the commerce, curtail to some extent the state's regulatory power. But that is a legislative, not a judicial function, to be performed in the light of the Congressional judgment of what is appropriate regulation of interstate commerce, and the extent to which, in that field, state power and local interests should be required to yield to the national authority and interest.
>
> ...courts do not sit as legislatures, either state or national. They cannot act as Congress does when, after weighing all the conflicting interests, state and national, it determines when and how much the state regulatory power shall yield to the larger interests of a national commerce. 303 U.S. 177, 189-90 (1938)

[16] 322 U.S. 292 (1944).
[17] *Id.* at 301.

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> The differing views of members of the Court in this and related cases illustrate the difficulties inherent in the judicial formulation of general rules to meet the national problems arising from state taxation which bears in incidence upon interstate commerce. These problems, it seems to me, call for Congressional investigation, consideration, and action. The Constitution gives that branch of government the power to regulate commerce among the states, and until it acts I think we should enter the field with extreme caution.[18]

Almost 50 years later, in seminal case *Quill Corp. v. North Dakota*,[19] discussed *infra*, the Court reminded Congress of its role in the resolution of state tax jurisdictional issues. *Quill* involved a challenge to a state use tax collection obligation that was imposed on all potential sellers that made "regular or systematic solicitation of a consumer market" in the state.[20] Upholding under *stare decisis* its prior holding in *National Bellas Hess, Inc. v. Department of Revenue*[21] where it invalidated a state sales and use tax collection obligation imposed on a business with no physical presence in the state, the Court stated that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today."[22] In reaffirming *Bellas Hess*, the Court noted that

[18] *Id.* at 302.
[19] 504 U.S. 298 (1992).
[20] *Id.* at 302-03.
[21] 386 U.S. 753 (1967), discussed *infra*.
[22] *Id.* at 311.

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> This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve.[23]

More recently, the Court again reminded Congress of its power to resolve interstate tax issues that fall on the application of the negative Commerce Clause. In *MeadWestvaco Corp. v. Ill. Dep't of Revenue*,[24] the Court considered whether the State of Illinois constitutionally taxed an apportioned share of the capital gain realized by an out-of-state corporation on the sale of one of its business divisions. In vacating the decision of the Appellate Court of Illinois that had upheld the tax, Justice Thomas in his concurrence, stated as follows:

> To the extent that our decisions addressing state taxation of multistate enterprises rely on the negative Commerce Clause, I would overrule them. As I have previously explained, this Court's negative Commerce Clause jurisprudence "has no basis in the Constitution and has proved unworkable in practice." (Citations omitted).
>
> . . . the Court's involvement in this area is wholly unnecessary given Congress' undisputed authority to resolve income apportionment issues by virtue of its power to regulate commerce "among the several States." See U.S. Const., Art. I, § 8, cl. 3.

[23] *Id.* at 318 (footnote omitted).
[24] 2008 U.S. LEXIS 3473, 6-7 (U.S. Apr. 15, 2008).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

> Although I believe that the Court should reconsider its constitutional authority to adjudicate these kinds of cases, neither party has asked us to do so here, and the Court's decision today faithfully applies our precedents. I therefore concur.

Perhaps the most telling messages from the Court to Congress can be found in the repeated denials to petitions for write of *certiorari* in matters involving conflicting state laws related to the assertion of jurisdiction to impose income tax on out-of-state companies. Such denials are discussed *infra*.

III. CONGRESSIONAL OBLIGATION TO EXERCISE ITS AFFIRMATIVE POWER UNDER THE COMMERCE CLAUSE TO ADDRESS INCONSISTENT JURISDICTIONAL NEXUS STANDARDS

A. Congressional Obligation to Uphold the Constitution

Under the Constitution, members of Congress are required to take an oath "to support th[e] [C]onstitution."[25] Specifically, under the U.S. Code, members of Congress must

> solemnly swear . . . [to] support and defend the Constitution of the United States against all enemies, foreign and domestic; . . . [to] bear true faith and allegiance to the same; . . . [to] take this obligation freely, without any mental reservation or purpose of evasion; and . . . [to] well and faithfully discharge the duties [of their office].[26]

Notwithstanding this inherent obligation, Congress has failed to fulfill its oath by invoking its affirmative powers under the Commerce Clause to resolve the confusion surrounding

[25] U.S. Const. art. VI, cl. 3.
[26] 5 U.S.C. § 3331(2000).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

state nexus standards and to move the impediments to interstate commerce created by inconsistent state jurisdictional standards for business activity taxes.[27] Except for the 1959 adoption of P.L. 86-272, which is limited to sales of tangible personal property under limited conditions and applying solely to net income taxes, Congressional direction and leadership in this important area affecting the national economy have been much less than desirable.

Congressional tendency to leave resolution of contentious constitutional-based problems to the courts, was recognized in an article written a quarter of a century ago by Judge Abner J. Mikva of the United States Court of Appeals for the District of Columbia Circuit. In his article, Judge Mikva criticized Congress for passing over constitutional-based decisions, and leaving such issues to the courts for resolution:

> Constitutional issues often present the most difficult value conflicts in society. The very knowledge that the courts are there, as the ultimate nay-sayers, increases the tendency to pass the issue on, particularly if it is politically controversial. Such behavior by Congress is both an abdication of its role as a constitutional guardian and an abnegation of its duty of responsible lawmaking.[28]

[27] There are two ways that this affirmative power can be exercised by Congress: (1) by preventing states from exercising their own powers to regulate under the negative commerce clause; and (2) by removing existing restraints on state regulation taxation judicially developed under the negative commerce clause. See Hellerstein & Hellerstein, STATE TAXATION 4.23; *see also* Prudential Ins. Co. v. Benjamin, 328 US 408 (1946).

[28] Abner J. Mikva, *How Well Does Congress Support and Defend the Constitution?*, 61 N.C.L. Rev. 587, 610 (1983).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

Congress has been particularly hesitant to prevent "certain impediments to interstate commerce" from persisting.[29] Arguably, by not focusing on the need to establish a clear standard by which business activity tax jurisdiction could be measured, Congress is, in effect, failing to meet its full responsibilities under the Constitution. There are those who would go so far as to say that its failure to act may necessarily imply legislative bad faith.[30]

So why doesn't Congress act to remove the blatant impediments to interstate commerce caused by the surfeit of imprecise and conflicting jurisdictional standards for imposition of state business activity taxes? The hesitancy to act may in part be function of federalism concerns.[31] As a constitutional principle, federalism is a double edged sword: it both limits the federal government from encroaching upon states' rights, but also empowers the federal government to carry out duties assigned to it that concern matters of national intent.[32]

From a state perspective, federalism is a matter of state sovereignty, a principle that allows a state to act in its own best interest and to tax within its own borders as it sees fit.

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[29] Robert H. Bork and Daniel E. Troy, *The Federalism Symposium: The United States Chamber of Commerce: Institute for Legal Reform: Locating the Boundaries: The Scope of Congress's Power to Regulate Commerce*, 25 Harv. J.L. & Pub. Pol'y 849, 870 (2002).
[30] Louis Fisher, *Constitutional Interpretation by Members of Congress*, 63 N.C.L. Rev. 707, 744 (1985).
[31] The American Heritage Dictionary defines federalism as (a) A system of government in which power is divided between a central authority and constituent political units. (b) Advocacy of such a system of government. The American Heritage Dictionary of the English Language, Fourth Edition. Houghton Mifflin Company, 2004. 26 Apr. 2008. <Dictionary.com http://dictionary.reference.com/browse/federalism>.
[32] *See* Bork & Troy, *supra* note 29.

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Under this concept, the federal government under the U.S. Constitution was created with limited powers,[33] and states retain sovereignty authority. As explained by James Madison:

> The powers delegated by the proposed Constitution to the federal government are few and defined. Those which are to remain in the State governments are numerous and indefinite. . . . The powers reserved to the several States will extend to all the objects which, in the ordinary course of affairs, concern the lives, liberties, and properties of the people, and the internal order, improvement, and prosperity of the State.[34]

Congressional reluctance in exercising its power under the Commerce Clause to establish a consistent jurisdictional taxing standard may be related to the fact that historically Congress has tread lightly on matters impacting state sovereignty.[35] Congress has nonetheless asserted its power under the Commerce Clause to define the scope of state authority to tax numerous times;[36], can be found in P.L. 86-272, discussed below is Congress' most plenary, comprehensive enactment in this area.

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[33] "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const., Amdt. 10.

[34] THE FEDERALIST NO. 45 (James Madison).

[35] *See* Charles E. McLure, Jr. & Walter Hellerstein, *Congressional Intervention In State Taxation: A Normative Analysis of Three Proposals*, 31 State Tax Notes 721 (Mar. 1, 2004).

[36] Examples include the Federal Aviation Act (prohibiting state and local governments, *inter alia*, from levying a ticket tax, head charge, "flyover" tax or gross receipts tax on individuals traveling by air); the Mobile Telecommunications Sourcing Act (prohibiting 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 (prohibiting states from taxing Amtrak ticket sales or gross receipts); Public Law 104-95 (prohibiting states from taxing pension income unless the pensioner resides in that state); the ICC Termination Act of 1995 (prohibiting states from taxing interstate bus tickets); the Miscellaneous Revenue Act of 1981 (prohibiting 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 (prohibiting states from imposing differing taxes on railroad property); and the Soldiers and Sailors Civil Relief Act of 1940 (limiting state taxation of members of the Armed Forces to the member's state of residence). *See generally* William J. Quirk & C.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

B. Public Law 86-272

In 1959, in response to the public concern about the implications of the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*,[37] where a business had a fully staffed in-state sales office, Congress enacted legislation that prohibited state taxation of net income from interstate commerce where the only in-state activity is the solicitation of orders for tangible personal property. In *Northwestern States*, the Court held that net income from the interstate activities of an out-of-state business may be subjected to state taxation, provided that the tax is nondiscriminatory and fairly apportioned to local activities.

The Court's treatment of two cases that had been pending when *Northwestern States* was decided engendered the swift enactment by Congress of a statute known as P.L. 86-272 which sets forth certain minimum standards for the exercise of state power to impose a net income tax.[38] It also authorized a Congressional study of uniform standards that should be applied by states in taxing income of interstate businesses.[39]

Rhett Shaver, *Does Congress Put Federalism at Risk by Limiting States' Power to Tax?*, 92 TAX NOTES 1489 (Sept. 7, 2001).

[37] 358 U.S. 450 (1959), discussed *infra*.

[38] Title I of Pub. L. 86-272, codified as 15 U.S.C. §§ 381-384, forbids the imposition of a tax on the net income of out-of-state company where such income is derived from activities within a state, if those activities are limited to the solicitation of orders that are approved, filled, and shipped from a point outside the State.

[39] *Id.*

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In 1964 and 1965, the House of Representatives' Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary issued a detailed report to Congress.[40] Sometimes referred to as the Willis Report,[41] the study refers to existing state tax laws as "the product of a nonobjective artist"[42] and stresses the need to reduce the "multiplicity, variety and mutability" of the multistate tax system.[43] The report concludes as follows:

> Certainly, the problems presented are not easy problems, but they are important problems. They are important to the states, and they are important to the vitality of the American common market. Congress has a responsibility to both, and it is time for it to seek a solution.[44]

Despite these clear recommendations, Congress has yet to act on its own recommendations or to deal in any meaningful way to provide parameters to state taxation beyond P.L. 86-272.[45] Legislative proposals for modernizing P.L. 86-272 and to expand its applicability to all business activity taxes and to sales of both tangible and intangible property will be discussed *infra* in Part IV.

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[40] H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Rep. No. 565, 89th Cong., 1st Sess. (1965); H.R. Rep. No. 952, 89th Cong., 1st Sess. (1965).
[41] Named after Congressman Edwin E. Willis who chaired the Subcommittee.
[42] *Supra* note 40 at 594.
[43] *Id.* at 384.
[44] *Id.* at 599.
[45] Michael T. Fatale, *Geoffrey Sidesteps Quill: Constitutional Nexus, Intangible Property and the State Taxation of Income*, 23 Hofstra L. Rev. 407, 452 n. 269; Kathleen L. Roin, *Note, Due Process Limits on State Estate Taxation: An Analogy to the State Corporate Income Tax*, 94 Yale L.J. 1229, 1233 n. 69 (1985).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

IV. EVOLUTION OF A JUDICIAL PHYSICAL PRESENCE STANDARD FOR STATE TAX NEXUS

A. The Modern Era of Commerce Clause Jurisprudence and the Evolution of Physical Presence Requirements in the State Tax Context

Since 1954, the Supreme Court has applied physical presence as a measure of a state's authority to tax. In *Miller Brothers Co. v. Maryland*,[46] the Court established that an out-of-state business with no in-state physical presence could not be required to collect use taxes on sales to in-state consumers. The Court applied a due process analysis and found that a use tax collection responsibility could only be imposed where there is "some definite link, some minimal connection, between [the] state and the person, property or transaction it seeks to tax."[47] Because there were no such links or connections to the state (other than the presence of consumers), the Court rejected as a burden to interstate commerce, the imposition of a use tax.

Physical presence was again the focus of the Court's analysis in *Northwestern States Portland Cement Co. v. Minn.*[48] In that case the Court attempted to clear up the "tangled underbrush of past cases"[49] with regard to the taxing powers of states, and held that the net income of an out-of-state business could be taxed only with respect to in-state activities.

[46] 347 U.S. 340 (1954).
[47] 347 U.S. at 344-45.
[48] 358 U.S. 450 (1959).
[49] *Id.* at 457.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

Physical presence within a state created the necessary connection to support taxation of the interstate activity.[50]

The first case to explicitly set forth the rule that actual physical presence is required to sustain a state's taxing authority from a commerce clause challenge was *National Bellas Hess, Inc. v. Department of Revenue*.[51] The Court there rejected a state's argument that a use tax collection obligation could be imposed on a mail order company whose only connection with a state was the solicitation for sales of goods to in-state customers with delivery via common carrier.

Bellas Hess was a Missouri-based mail-order company with customers throughout the United States, including Illinois. Bellas Hess' only contact with the state was through U.S. mail. Potential Illinois customers were routinely sent catalogs from Bellas Hess and customers would place orders via U.S. mail sent from Illinois to Missouri. Orders were accepted, filled and shipped from outside of Illinois, and goods would be shipped to customers via interstate carrier.

Despite the fact that Bellas Hess had no employees, salespersons, agents or property in Illinois, the state argued that Bellas Hess had established a minimal connection with Illinois. The basis of Illinois' argument was essentially that

[50] *Id.* at 454-55. This case ultimately led to the passage of Public Law 86-272, which restricted a state's power to tax sales of tangible personal property even where certain physical presence requirements were met. See *supra* Part III.
[51] 386 U.S. 753 (1967).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

it had created a market for Bellas Hess to exploit, and therefore had the requisite nexus for use tax collection purposes.

In rejecting the state's argument, the Court found that simple exploitation of the market was not enough to create nexus; something more was required in the form of a physical presence in the state. In its decision, the Court relied on the underlying purpose of the Commerce Clause which is "to ensure a national economy free from such unjustifiable local entanglements."[52]

In *Complete Auto Transit Inc. v. Brady,*[53] the Court extended its rationale in *Bellas Hess* to all forms of state taxes. Focusing on the potential effect of the tax on interstate commerce (rather than on the particular type of tax), the Court articulated a four part test, and held that a tax on interstate commerce will be sustained where it is "[1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."[54]

[52] 386 U.S. at 510.
[53] 40 U.S. 274 (1977).
[54] *Id.* at 279.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

In 1991, fourteen years after deciding Complete Auto Transit, the Court in *Quill*[55] addressed the issue presented by first prong of the Complete Auto Transit test - that of substantial nexus. In so doing, the Court, upheld in the context of sales and use taxation, the physical presence requirement of *Bellas Hess*.

Quill, a seller of office equipment and supplies, was a Delaware corporation with offices and warehouses located in states outside of North Dakota. Quill had no employees or property in the state, and its contacts with North Dakota consisted of sales solicitations in the form of catalogs sent through U.S. mail, advertisements and telephone calls. All merchandise was sent by Quill from outside the state to approximately 3,000 North Dakota customers. On the basis of these contacts, and notwithstanding the fact that Quill had no physical presence in the state, North Dakota sought to impose a use tax collection obligation on Quill.

In its decision, the Court made clear that claims of constitutionality under the Due Process and Commerce Clauses were distinct and involved different standards and concerns. While Due Process is concerned with fundamental fairness and thus does not require physical presence but merely mandates minimum contacts in order to justify state taxation, the

[55] 504 U.S. 298 (1992).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

Commerce Clause necessitates more: physical presence. In explaining why physical presence was required under the Commerce Clause to sustain a use tax collection obligation, the Court discussed the intent of the Framers of the Constitution to provide a mechanism to deal with state taxes that "hindered and suppressed interstate commerce."[56] A bright line rule, such as physical presence, the Court reasoned, would best define the limits of state authority to tax. Under such a test, Quill had no such presence, and North Dakota was unable to constitutionally impose a use tax collection responsibility.

B. Applicability of *Quill* to Business Activity Taxes

While *Quill* provided much clarity and certainty in the sales and use tax area, at least with regard to the types of contacts Quill had with the state of North Dakota, the case has been unable to provide a decisive answer to the question of whether physical presence is also required under the Commerce Clause for purposes of business activity taxes. Arguably, the need for a physical presence standard is even more warranted in the case of business activity taxes than for sales and use taxes. This is so because of the sheer number and complexity of different types of business activity taxes as compared to sales and use taxes which tend to differ only as to rates. Such diversity and complexity

[56] 504 U.S. at 312.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

creates staggering compliance and economic burdens on multistate companies.[57] However, applicability of *Quill* to taxes other than sales and use taxes is still an undecided issue, and one that the Supreme Court is apparently unwilling to resolve.

A well-known example of the Supreme Court's unwillingness to tackle business activity tax jurisdictional issues was *Geoffrey, Inc. v. South Carolina Tax Commission,*[58] a case that arose from a state court's decision to uphold a net income-based tax against an out-of-state company with no physical contacts in the state. Geoffrey, Inc., a Delaware corporation, was a wholly-owned subsidiary of Toys 'R' Us, Inc. that held certain intellectual property, including trademarks and trade names of Tots 'R' Us. Under a licensing agreement with Toys 'R' Us, Geoffrey received a one percent royalty on certain net sales Toys 'R' Us. The issue in *Geoffrey* arose when Toys 'R' Us, which did business in South Carolina, attempted to deduct royalty payments made to Geoffrey. While the deductions were ultimately allowed, South Carolina asserted jurisdiction over Geoffrey based on an "economic presence" standard, and imposed tax on Geoffrey's royalty income attributable to South Carolina. Geoffrey unsuccessfully challenged the authority of South Carolina, arguing that because no physical presence was created

[57] *See* 2007-9 NYU INSTITUTE ON STATE & LOCAL TAXATION § 9.03. *See also* Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division,* Univ. Mich. Bus. Sch. (Sept. 2002).
[58] 313 S.C. 15; 437 S.E.2d 13 (S.C. 1993), *cert. den.* 114 S.Ct. 550 (1993).

by the existence of intangibles in the state, South Carolina's imposition of the tax violated *inter alia* the Commerce Clause of the U.S. Constitution. The South Carolina court's decision to uphold the tax created an uproar in the multistate tax world, made worse by the fact that the Supreme Court subsequently declined to hear the case.

Several years after *Geoffrey*, another request was made to the Supreme Court to resolve the nationwide controversy over state nexus standards for business activity taxes. In *A&F Trademark, Inc. v. North Carolina*,[59] the issue presented in a petition for *certiorari* was whether the physical presence Commerce Clause standard set forth in *Quill* applied to all state taxes, as some state courts had concluded, or only to state sales and use taxes, as held by courts in other states. Petitioners there were Delaware holding companies wholly owned by Limited, Inc. Headquartered and located in Delaware, the holding companies received royalties from licensing arrangements they had with various other Limited, Inc. subsidiaries operating stores in several states, including North Carolina. Although the petitioners had no physical presence in North Carolina, the North Carolina Department of Revenue, based on an "economic presence" approach, assessed the holding companies for corporate

[59] 167 N.C. App. 150, 605 S.E.2d 187, 2004 N.C. App. LEXIS 2162, 11 A.L.R.6th 873 (2004); *cert den.* 546 U.S. 821, 126 S. Ct. 353 (2005).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

income and franchise taxes on the royalties. The petitioners appealed the decision of the North Carolina Court of Appeals upholding the state's authority to impose the tax; on October 3, 2005, the Supreme Court denied *certiorari*.[60]

The Supreme Court recently denied certiorari again in *Lanco, Inc. v. Director, Div. of Taxation*[61] and *FIA Card Services NA (f/k/a MBNA America) v. West Virginia Tax Commissioner*.[62] Lanco Inc. and MBNA filed virtually simultaneous certiorari petitions with the Supreme Court challenging respective business activity tax nexus rulings in New Jersey and West Virginia. Lanco Inc., a Delaware corporation that licensed intellectual property to a women's clothing store with locations in New Jersey, challenged as violative of the Commerce Clause, the taxing of licensing income by New Jersey where the company otherwise lacked physical presence in that state. FIA Card Services N.A. also challenged as unconstitutional under the Commerce Clause, a state's assertion of tax where no physical presence existed. Specifically, FIA Card Services challenged a state court opinion that upheld West Virginia business franchise and corporate tax imposed on MBNA America Bank N.A., FIA Card Service's predecessor. MBNA was incorporated in Delaware, but had no physical presence in West Virginia. Its only connection

[60] 546 U.S. 821, 126 S. Ct. 353 (2005).
[61] 188 N.J. 380 (N.J. 2006); *cert. den.* 127 S. Ct. 2974 (U.S. 2007).
[62] 220 W. Va. 163 (W. Va. 2006).

to that state was in issuing credit cards and serving West Virginia credit card customers. The West Virginia Supreme Court held that because of MBNA's "significant economic presence" in the state, imposition of franchise and corporate taxes did not violate the U.S. Constitution.

Despite the high hopes of industry groups, many of which filed amicus briefs urging the extension of *Quill* to all state taxes,[63] on June 18, 2007, the Supreme Court once again denied *certiorari*. The Court's message in declining to hear these cases seems very clear, and it takes little imagination to discern who is now left with the responsibility of resolving the longstanding questions over the standards by which a state may constitutionally impose a state tax without burdening interstate commerce.

It also is easy to understand how financially strapped states see denials of certiorari, along with the apparent unwillingness of Congress to act, as opportunities to increase their taxing authority over out-of-state businesses with no physical in-state presence.[64] Just as the Framers of the Constitution warned, unless restrained states operate naturally in their own best interests. FN HAMILTON?

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[63] *See, e.g.*, Amicus Brief of Amicus Curiae, Tax Executives Institute, Inc., 2006 U.S. Briefs 1228A; 2007 U.S. S. Ct. Briefs LEXIS 847 (May 8, 2007) filed in FIA Card Services, N.A., fka MBNA v. Tax Commissioner of the State of West Virginia, 127 S. Ct. 2997, 168 L. Ed. 2d 719, 2007 U.S. LEXIS 7868, 75 U.S.L.W. 3678 (U.S. 2007).
[64] *See Interstate Commerce Coalition Applauds Introduction of BAT Simplification Act*, 2008 TNT 27-41 (February 7, 2008).

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An example of this can be found in the reaction of the New Hampshire legislature just two days after the Supreme Court denied certiorari in *Lanco* and *MBNA*.[65] Amending its statutory definition of business activity to include "a substantial economic presence evidenced by a purposeful direction of business toward the state," the state made clear that it does not intend to follow *Quill* with respect to its business profits tax. Such actions by states to reach out-of-state businesses and to increase revenues at the expense of a national economy are the very reasons why Congress needs to enact a clear physical presence standard applicable to all business activity taxes.

V. EXAMINATION OF PROPOSED BUSINESS ACTIVITY TAX SIMPLIFICATION ACT AND COUNTER PROPOSALS

A. Proposed Legislation

Two identical bills have recently been introduced in Congress, one in the Senate and one in the House of Representatives. These bills would create a federally mandated nexus standard for state business activity taxes.[66] Similar to prior bills that were never enacted into law,[67] the proposed legislation, collectively referred to as "BATSA," would

[65] *News Analysis: New Hampshire Adopts Economic Nexus Standard*, 2007 STT 137-13 (July 16, 2007).
[66] *See supra* note 5.
[67] Business Activity Tax Simplification Act of 2005, H.R. 1956, 108th Cong. (2005); Business Activity Tax Simplification Act of 2006, S. 2721, 109th Cong. (2006); H.R. 1956. Both bills sought to impose a physical presence standard for business activity taxes, as well as to expand the scope of P.L. 86-272 to include the sale of intangibles and services.

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essentially do two things: (1) expand the scope of P.L. 86-272 with respect to protected activities, covered sales and transactions, and applicable taxes; and (2) provide a clear minimum jurisdictional standard of physical presence with respect to the imposition of state business activity taxes.

1. Modernization of P.L. 86-272

BATSA would broaden the scope of P.L. 86-272 to cover not only sales of tangible personal property shipped or delivered from out-of-state, but also the sale (or potential sale) and transactions of all forms of property and services "fulfilled or distributed from a point outside the State."[68]

Protected activities would be expanded from the mere solicitation of orders to (1) the furnishing of information to customers or affiliates; (2) the coverage of events or other in-state gathering of information or his representative, when such information is used or disseminated from out-of-state; or (3) activities directly related to the potential or actual purchase of goods or services within the State where the final decision to purchase is made out of state. These expanded activities would also be protected where performed by an independent contractor on behalf of the person through maintenance of an office in the state, or where an independent contractor is furnished information "by such person ancillary to the

[68] *Id.*

solicitation of orders or transactions by the independent contractor on behalf of such person."[69]

Most important, the provisions would apply to all business activity taxes, not simply to net income taxes as is the case with P.L. 86-272. "Business activity tax" under the legislation is defined as any net income-type tax "measured by the amount of, or economic results of, business or related activity conducted in the State."[70] The intent of the bills is presumably that a sales or use tax, or any transaction tax on the specific sales or acquisitions of goods and services, would not be included.[71]

2. Codification of a Physical Presence Standard

The second primary feature of the legislation is the adoption of the *Quill* nexus standard for business activity taxes. BATSA creates a bright-line jurisdictional requirement that would need to be met before a state business activity tax could be imposed.[72] Specifically, a state business activity tax could not be imposed unless the taxpayer had physical presence during the taxable year. The physical presence requirement would be met by (1) an individual's physical "being" in a state, or by assigning an employee to "be" in the state; (2) using the

[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.* A "state" for purposes of BATSA includes 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."

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

services of a non-employee agent in the state to establish or maintain a market in the state, but only where the agent performs services in the state exclusively for the potential taxpayer; or (3) leasing or owning tangible personal or real property in the state.[73]

Certain *de minimis* activities would not give rise to physical presence within meaning of BATSA. These would include the 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 presence in a state to conduct "limited or transient business activity."[74]

Finally, BATSA makes clear that the physical presence requirement does not apply where an individual or domestic business entity is domiciled, incorporated, formed or a resident of the state. In addition, under the legislation, a state is not prohibited from imposing a tax on the owner or beneficiary of a partnership, S corporation, limited liability company (taxed for federal purposes as a partnership), trust, estate or other entity, where physical presence by the entity otherwise exists in the state.[75]

B. Proposal for an Alternative Federal Jurisdictional Standard

[73] *Id.*
[74] *Id.*
[75] *Id.*

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

In place of a physical presence standard, some have endorsed the Congressional enactment of an economic presence approach to state business activity tax nexus. Under the guise of such sound tax policy principles such as equity and efficiency, these proponents argue that economic realities, as opposed to physical presence, should be the standard by which nexus is measured for purposes of state business activity taxes.

As an example, the New York State Bar Association's Tax Section recently issued a letter to Congress ("New York Tax Report")[76] recommending the adoption of a nexus standard that takes into account economic presence. Asserting that such a standard would provide certainty and clarity, the proposal calls for a "*de minimis* economic threshold."[77]

Arguments that the New York Tax Section makes in favor of an economic presence standard include the "viable marketplace" justification, concept based on the principle that a business should pays it "fair share" whenever it derives economic benefits of a state's marketplace.[78] It is further argued that a physical presence of a business is often unrelated to the business activity in the state, and that economic presence is a

[76] *See supra* note 6. <http://www.nysba.org/AM/Template.cfm?Section=Tax_Section_Reports_2008&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=13360>
[77] *Id.* at page 2.
[78] *Id. See also* John S. Swain, *State Income Tax Jurisdiction: A Jurisdictional and Policy Perspective*, 45 Wm and Mary L. Rev. 319, 377.

better gauge of actual in-state business activity.[79] The New York Tax Section also claims that a physical presence standard would create incentives for a business to manipulate its nexus with a state, resulting in potentially artificial and inefficient transactions.[80]

Although the specifics as to how such a standard would work are unclear,[81] the New York Tax Section concludes that a nexus standard that incorporates an economic presence requirement would strike a proper balance between the revenue needs of states, and the fairness and certainty needs of out-of-state taxpayers.[82]

The New York Tax Section and other advocates of the codification of an economic presence standard make flawed arguments, and fail to consider some of the grave consequences that could arise if Congress were to adopt an economic presence standard. The next section will explain how the policy arguments advanced by the New York Tax Section and others are misguided and overlook key policy considerations, such as the need for consistency with the international jurisdictional standards.

[79] New York Tax Report at page 8.
[80] *Id. See also* John S. Swain *supra* note 78.
[81] Presumably, under the proposal a business could be subjected to a state's business activity taxes on the basis of either physical presence or economic presence.
[82] New York Tax Report at 4.

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1. The Viable Marketplace Fallacy

A long standing premise upon which a state tax may be asserted is that where an out-of-business receives sufficient benefits and protections from a state, imposition of a state tax is justifiable.[83] The Supreme Court recognized this fundamental principle in *Wisconsin v. J.C. Penney Co.* when it stated that "The simple but controlling question is whether the state has given anything for which it can ask return."[84] Thus, New York Tax Section and other proponents of an economic presence standard argue that because an out-of-state seller receives benefits of a "viable marketplace" when in-state consumers are accessed, imposition of a tax on the activities of that out-of-state business is justifiable.[85] Such arguments are fundamentally flawed for several reasons.

First, a "viable marketplace" is something that is created by a state for the benefit of its own residents - not for the benefit of remote sellers with no in-state physical presence.[86] A state that is fortunate enough to be able to provide its residents with opportunities to purchase the goods and services of an out-of-state business, which opportunities the residents can freely accept or reject, is doing precisely what it is

[83] Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940).
[84] *Id.*
[85] *See* New York Tax Section Report, *supra* note 6.
[86] Lanco, Inc. v. Director, Division of Taxation, Amicus Brief of the Greater Philadelphia Chamber of Commerce and the Chamber of Commerce Southern New Jersey; 2006 U.S. Briefs 1236C, 17 (U.S. May 8, 2007).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

supposed to do for its residents.[87] To reward such a state by allowing it to tax an out-of-state business with no physical presence is essentially permitting a state to deliberately export its tax burden to non-residents that have no "say" in the state's political process.[88] This sort of state-centered action at the expense of interstate interests is precisely what the Framers of the U.S. Constitution sought to guard against when they drafted the Commerce Clause to replace the Articles of the Confederation.

Second, in answering the question articulated in *J.C. Penney* as to what benefits and protections a state provides an out-of-state business whose only physical contact with a state is resident customers, it is virtually impossible to find anything but incidental and inchoate benefits. Such a company receives very little, if any, government services at all, including police and fire protection for its property and personnel, education for its employees, or anything that could possibly justify a state's imposition of tax.[89] Without some in-state physical presence of the potential taxpayer, a state gives

[87] *Id.*
[88] *Id.*
[89] Arthur Rosen, *The Invalidity of the "Economic Nexus" Principle is Clear*, 20 State Tax Notes 1538 (April 20, 2001).

nothing to the out-of-state business "for which it can ask a return."[90]

Finally, the exploitation-of-the-marketplace theory focuses solely on due process requirements of fairness, and ignores the Commerce Clause requirement of substantial nexus - an important check on the effects of state regulation on interstate commerce.[91] While it is acknowledged that Congress could choose to ignore substantial nexus concerns in adopting a jurisdictional standard for state taxes, the underlying importance of the Commerce Clause should be heeded by the legislature,[92] and states should not be permitted to unduly burden interstate commerce by asserting tax on an out-of-state business based on a nebulous jurisdictional test. Adopting anything less than a physical presence standard would work against the ideal of a strong, national and unified economy and would invalidate longstanding principles of federalism.[93]

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[90] J.C. Penney at 444. Anything received by the out-of-state business with no physical presence would likely be along the lines of a general benefit or protection for which as members of society as a whole, federal taxes are paid. *See Business Activity Tax Nexus: A Chance for Congress to Call the Game*, 2003-5 NYU Institute On State & Local Taxation § 5.04. At least one commentator has raised the issue that indeed an action for malfeasance may even arise against a state government seeks to provide benefits to an outside business with no in-state physical presence. *See* Rosen *supra* note 91.

[91] *See* Quill, 504 U.S. at 312.

[92] *See* Quill, 504 U.S. at 304. (". . .Congress has plenary power to regulate commerce among the States and thus may authorize state actions that burden interstate commerce.") *See also* International Shoe Co. v. Washington, 326 U.S. 310, 315 (1945).

[93] Peter L. Faber, *Should the States Determine Their Own Tax Destinies? Federalism in the 21st Century*, 40 State Tax Notes 111 (April 10, 2006).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

2. Economic Realities and Inefficiency Arguments

Opponents of the BATSA physical presence standard also argue that the fundamental premise underlying physical nexus is obsolete in an electronic world, and that an economic presence test better reflects the realities of current business models. The New York Tax Section even goes so far as to claim that physical presence often has no correlation to in-state activities and that therefore nexus should not depend solely on the physical location of employees, real property or capital investment.[94]

Basing a nexus standard on such claims would be unsound from both an economic and a tax policy standpoint. The fundamental flaw of those advocating a nexus standard based on economic presence is that they fail to distinguish between out-of-state businesses that have merely participated *with the economy* of another state, and those that participate *in the economy* of that state. The latter would necessitate as a practical matter a physical aspect evidencing a revenue-generating activity.[95]

In addition, whether a company does business over the Internet or from a brick and mortar storefront, labor and capital will always be needed in order to generate or earn

[94] New York Tax Report at 8.
[95] This argument has also been made in the international tax context. *See* Gary D. Sprague & Rachel Hersey, *Permanent Establishments And Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, 38 Ga. L. Rev. 299, 312 (2003).

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

income.[96] And it is precisely where the labor and capital investment, as well as risk of investment is located, that the "taxable" value is ultimately created, and where the incidence of business activity tax should naturally fall. Merely accessing a market through electronic means creates no inherent value to the out-of-state business upon which a tax should be asserted.

Along these same lines, proponents of an economic presence standard also make the tenuous argument that requiring a physical presence would create economic inefficiencies in that out-of-state businesses would have artificial incentives to stay physically out of the state, while presumably stepping up electronic dealings with in-state residents.[97] The fear is that businesses could manipulate the form of their transactions in order to shift income away from a state.

To the contrary, however, economic efficiencies are actually created by allowing out-of-state businesses to promote their interests through e-commerce without concern about whether their non-physical, remote contacts will create a taxing obligation. Also, the development of electronic and other means of doing business enhances and increases overall business opportunities across the board, in all states. Collectively, without resorting to amorphous, hard-to-apply nexus standards,

[96] Note that it would be virtually impossible for a U.S. business to avoid nexus entirely, or to develop all business through non-physical means. For a like argument in the international tax context, see Reuven S. Avi-Yonah, *Tax Competition and E- Commerce*, Worldwide Tax Daily, Sept. 17, 2001, 2001 WTD 180-11.
[97] New York Tax Report at 8.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

every taxing jurisdiction should benefit from a changing business model that provides its in-state residents and those operating physically in-state, with new ways of reaching customers.

Finally, a business decision to move labor and capital from one jurisdiction to another would never be done for other than bottom-line, economic reasons. In that sense, asserting that such behavior is somehow "artificial" is illogical and runs counter to fundamental principles of economics.

3. Considerations of Clarity, Compliance Burdens and Administrative Workability

Another ludicrous argument made by those advocating an economic presence component to federally mandated nexus standards is that there are clearer, easier and more workable ways of determining taxable presence than the "bright line" physical presence test delineated in *Quill*.[98] This argument is completely unsupported, and seems to be an attempt to legitimize a "fuzzy" nexus standard that would allow a state to continue asserting what amounts to a national tax jurisdiction over out-of-state companies with otherwise tenuous in-state ties.

The Court in *Quill* recognized the need to tighten up the nexus standard, to leave as little wiggle room as possible, and "to firmly establish the boundaries of legitimate state

[98] *Id.* at 8.

authority to impose" taxes.[99] The *Quill* Court, quoting *Northwestern States Portland Cement Co. v. Minnesota*,[100] further referenced the need for "precise guides to the States in the exercise of their indispensable power of taxation."[101] Adoption by Congress of an economic nexus standard (as either a stand alone test, or a hybrid one) would be anything but a "precise guide," and would lead to nothing but continuing disputes over the parameters of substantial nexus.

The Court in *Quill* also addressed the argument that bright line tests are artificial:

> Like other bright line tests, the *Bellas Hess* rule appears artificial at its edges: whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office. This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes.[102]

Thus, arguments made by the New York Tax Section that a physical presence standard is "artificial" and therefore should be rejected in favor of the less bright line test of economic presence, are unquestionably misplaced.

Moreover, an economic presence standard would result in a compliance nightmare for multistate businesses. A recent study estimates that there are over 3,300 business activity taxes

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[99] 504 U.S. 298, 315-316 (U.S. 1992).
[100] 358 U.S. 450, 3 L. Ed. 2d 421, 79 S. Ct. 357 (1959).
[101] 504 U.S. 298, 315-316 (U.S. 1992), quoting Northwestern Portland Cement , 358 U.S. 450, 457- 458, 3 L. Ed. 2d 421, 79 S. Ct. 357 (1959).
[102] 504 U.S. at 315. (Citations omitted.)

collected in state and local jurisdictions across the United States.[103] Rather than encouraging unification of a national market, an economic presence standard would discourage businesses from expanding operations due to bottom-line costs of managing and paying for taxes in multiple jurisdictions. In this way, such a standard would unduly interfere and burden interstate commerce - something that Congress is charged with protecting, not harming.

Finally, an economic presence would further exacerbate the difficulties that publicly traded companies are faced with in meeting stringent financial reporting requirements under the standards created under rules promulgated in 2006 by the Financial Accounting Standards Board (FASB). These rules, known as Financial Interpretation No. (FIN) 48, set forth the requirements for disclosing uncertain tax positions on financial statements.[104] Under FIN 48, each tax return position taken or expected to be taken - including the position that a company has insufficient nexus such that it does not have to file a state tax return - must be analyzed under a two step process.[105] Under the first step, a determination is made as to whether the return position is ultimately "more likely than not" to be upheld under

[103] *Companies Cite Ernst & Young Study in Petition to Supreme Court*, 2007 STT 51-1 (March 14, 2007). More than 12,600 business activity taxes have actnally been authorized by state and local governments. *Id.*
[104] FIN 48 is an interpretation of Financial Accounting Standard No. 109, Accounting for Uncertain Tax Positions On May 2, 2007, FASB issued FASB Staff Position No. FIN 48-1, an interpretation of FIN 48.
[105] Jean T. Wells and Gwendolyn McFadden-Wade, *Nexus and FIN 48: States of Flux*, 9-2007 J.A. 80 (2007).

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audit and court challenges. Such a determination is based on the technical merits of the position and the likelihood of prevailing on appeal. Where such likelihood is less then 50 percent, the position cannot be recognized on the financial statement, and a full reserve must be created for potential liability.[106]

FIN 48 and an economic presence standard are a lethal combination when one considers an out-of-state business with no in-state physical presence that would have to apply a standard that is other than a bright-line rule to determine whether sufficient nexus exists. If the test is one of economic presence, it will be more difficult to make the FIN 48 determination with a 50 percent confidence, and such a company will otherwise forced to accrue 100 percent of the potential tax liability, including any potential interest and penalties. Such consequences only add to the onerous burden on a business engaged in interstate commerce in states where it has no labor or capital.

4. International, National and Sub-national Tax Policies

If taken seriously, arguments such as those made by the New York Tax Section that some form of an economic presence standard should be adopted by Congress, threaten international relationships and the resulting cross-border trade between the

[106] *Id.*

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

United States and foreign nations. This is so because of the potential conflict with the longstanding jurisdictional tax standard known as "permanent establishment" that has been negotiated between the United States and the vast majority of developed nations.

Described in most bilateral tax treaties with the United States, this "permanent establishment" standard generally requires, when looked at from a U.S. perspective, that before a U.S. tax can be imposed, the non-resident have a fixed place of business in the United States through which its business enterprise is carried on. Examples of permanent establishments found in most bilateral tax treaties with the United States include warehouses, offices, branches and factories, but do not include certain types of physical presence that are deemed to be preparatory or auxiliary to creation of a permanent establishment.[107] Thus, the non-resident's requisite presence in the United States must be more than incidental, something that clearly points to a significant relationship between the nonresident and the United States such that imposition of a U.S. income tax would make sense and could be justified.

What is in effect a physical presence threshold of tax jurisdiction, the permanent establishment standard is the

[107] Model Tax Convention on Income and on Capital, art. 7 (Jan. 28, 2003), Organization for Economic Co-Operation and Development. .

international norm by which companies of developed nations assess and predict their cross border tax costs. Such calculations are crucial to global company's fiscal planning, and are routinely relied upon in the international context in determining whether and where to do business. The benefits of the physical presence standard in the international context was explained by Michael F. Mundaca, who is now Deputy Assistant Secretary for International Tax Affairs in the Treasury Department's Office of Tax Policy, when he testified before the Senate Committee on Finance in connection with the prior BATSA bill:

> [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.[108]

Mr. Mundaca further pointed out that a permanent establishment (i.e., physical presence) standard "helps to mitigate double taxation and prevent tax jurisdictional disputes, which is especially important in a global economy."[109]

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[108] Testimony of Michael F. Mundaca Before the Senate Committee on Finance, Subcommittee on International Trade, *How Much Should Borders Matter?: Tax Jurisdiction in the New Economy* (July 25, 2006).
[109] *Id.*

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

It is difficult to predict what the implications would be of the adoption of federally mandated state nexus standard that departs from the physical presence standard found in permanent establishment clauses of bilateral tax treaties. However, it is not difficult to imagine that imposition of an economic presence standard would have an adverse effect on foreign relations between the United States and its tax treaty partners. As Mundaca warns, enacting a less-than-physical presence standard would impact the global economy - presumably by discouraging in-bound investment into the United States.

Even more troubling are the proposed solutions to the anticipated international problems that would be created by enactment of a non-physical nexus standard that conflicts with permanent establishment principles. As an example, the New York Tax Section recommends that Congress consider, along with an economic presence standard, the possibility of enacting a separate nexus standard for non-U.S. residents. Aside from the problems related to discrimination of U.S. companies in favor of non-U.S. businesses,[110] a differentiated nexus standard between U.S. and non-U.S. residents would add unnecessary complexity to an already complex issue.

[110] *See* Zee Toys, Inc. v. County of Los Angeles, 85 Cal. App. 3d 763 (Ct. App. 1978), aff'd by an equally divided court sub nom. Sears, Roebuck & Company of Los Angeles, 449 U.S. 1119 (1981).

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It would also encourage the restructuring of multinational operations to benefit from the favorable nexus standards afforded to non-U.S. residents. For example, a U.S. company with operations (i.e., labor and capital) in the United States may decide to restructure its U.S. operations to locations overseas so that it can avoid onerous state taxation in the United States. Ironically, adopting an economic presence standard would likely create the very "artificial incentives" and "economically inefficient behavior" that the New York Tax Section warns a physical presence standard would create.[111] Rather than "incentiviz[ing] [sic]z inefficient behavior,"[112] a physical presence test could actually prevent the harmful transfer of U.S. labor and capital to an overseas parent or subsidiary company that could result by applying a physical presence standard to non-U.S. residents, while requiring a U.S. business to use an economic presence standard. Such a situation could only harm - not benefit - the U.S. economy.

In this regard, the enactment by Congress of an economic presence standard, or any standard that departs from a purely physical presence requirement, would run counter to Commerce Clause goals of maintaining a free flowing commerce in the

[111] New York Tax Report at 8.
[112] *Id.*

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United States, and could potentially interfere with important foreign relations.

5. The Promotion of Federalism

Congressional adoption of a clear physical nexus standard would also validate the principles of federalism. Such adoption would strike the correct balance between the national interest of a unified market, an interest over which Congress is charged with promoting and protecting, and the ability of states to tax as they see fit any business over which jurisdiction exists. By codifying as a physical presence standard, BATSA would allow the clear determination of whether and when a state has jurisdiction to tax, as opposed to how that tax should be measured.[113] Rather than treading on a state's right as to how it will tax those over which it is entitled to tax, BATSA would merely codify a physical presence standard and would make clear when (and when not) an out-of-state business could be subject to a state's taxing jurisdiction. This would ensure the free flow of national commerce.

Similar to state governmental reaction at the time in our country when the Articles of the Confederation were on the verge of being replaced with a document that would give the federal government the power to reign in abusive and far reaching state tax practices, state governments are now up in arms over having

[113] 2006-12 NYU INSTITUTE ON STATE & LOCAL TAXATION § 12.04.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

their sovereignty second guessed by BATSA. What is at stake, just as it was when the Constitution was being debated, is the ability of states to generate revenues from out-of-state interests that have no influence over government elections. Thus, any debate in Congress over BATSA (or over any proposals to restrict state taxing authority) will inevitably include state tax administrators who will contend that their respective states under the principles of federalism should be free to tax as they see fit. For example, this states' rights argument against the codification of a physical presence standard was made at a 2005 hearing of the House Judiciary Committee's Commercial and Administrative Law Subcommittee. Kansas Secretary of Revenue Joan Wagnon, who also represented 46 states as Multistate Tax Commission Chair, testified on against H.R. 1956, the Business Activity Tax Simplification Act of 2005:

> H.R. 1956 runs roughshod over federalism, placing Congress in the position of imposing a smorgasbord of federally-mandated state tax exemptions that would preempt hundreds of existing state and local laws and rules. For almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of states to raise revenues. . . .[114]

Such opponents of BATSA's physical presence standard, including most if not all state tax administrators as well as the New York Tax Section, obfuscate the true purposes of the

[114] Testimony of Joan Wagnon to Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary, United States House of Representatives on H.R. 1956, The Business Activity Tax Simplification Act of 2005 (September 27, 2005), reprinted at 2005 TNT 187-39 (September 27, 2005).

Commerce Clause. Rather than a sign of respect for state sovereignty as BATSA opponents would like to pretend, the Commerce Clause is, and was adopted as, a means of restraining state powers,[115] including the power to tax those engaging in interstate commerce. In that sense, BATSA promotes federalism by allowing the federal legislative branch of government to do what it is charged to do, while at the same time allowing states to tax those within their proper jurisdiction.

Ultimately, a physical presence test reinforces state sovereignty by helping to clearly delineate state geographic borders that are so important to our federalist system of government.[116] It is the physical boundaries that mark the outer limits of state taxing authority, and it is the physical nature of contacts within those borders that should guide a state's taxing authority. Eliminating a physical presence standard in favor of an economic one would allow a state to tax without reference to the physical boundaries that bring integrity to our federalist system.[117] To erase these boundaries by allowing states to tax out-of-state businesses based on non-physical economic ties to that state would create a system similar to the one that existed during the time of Articles of the

[115] Calvin H. Johnson, *Homage to Clio: The Historical Continuity from the Articles of Confederation into the Constitution*, 20 Const. Commentary 463, 496 (2003-2004).
[116] *See* Lanco, Inc. v. Director, Division of Taxation , Amicus Brief of the Greater Philadelphia Chamber of Commerce and the Chamber of Commerce Southern New Jersey; 2006 U.S. Briefs 1236C, 18 (U.S. May 8, 2007).
[117] *Id* at 19.

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

Confederation. To give each state a national taxing authority would be the result of Congressional adoption of anything less than a physical presence standard.

VI. CONCLUSION

At no time since shortly after the Revolutionary War, when States in response to a poor economy began to erect barriers to commerce in the form of fees, taxes and trade restrictions, has there been such a need for unification of our national commercial interests. Just as the Federal Convention of 1787 met to address the commercial "disunity" of the States and the resulting threat posed to a national economy, so must Congress step in now and remove current impediments to the continued development of a national market.

The outcome of the Federal Convention was ratification of the Commerce Clause which gave Congress the power to regulate interstate commerce. The outcome today must be the Congressional exercise of this power by enactment of federal jurisdictional legislation that would embody a physical presence standard for state taxation of business activity. Certainty, clarity, a more unified national market and a workable standard consistent with international tax policy would arise from the adoption of a nexus standard that imposes a strict physical presence requirement. Only then will we finally see the eradication of

Citation: 6 Pitt. Tax Rev. (forthcoming Spring 2009)

the "tangled underbrush"[118] that has developed over the years with respect to the requisite nexus that must exist before a state may properly impose a business activity tax on an out-of-state company.

[118] *Northwestern States Portland Cement*, 358 U.S. 450, 457 (1959)

LETTER FROM NATE K. GARVIS, VICE PRESIDENT, GOVERNMENT AFFAIRS & SR. PUBLIC AFFAIR OFFICER TARGET BRAND, INC.

The Power of Direct
Relevance. Responsibility. Results.

Jerry Cerasale
Senior Vice President,
Government Affairs

February 3, 2010

The Honorable Steve Cohen
Chairman
Subcommittee on Commercial and Administrative Law
Committee on Judiciary
U. S. House of Representatives
Washington, DC 20515

Dear Chairman Cohen:

In light of your scheduled hearing this week on "The Role of Congress in Defining Nexus," I am writing to express the Direct Marketing Association's (DMA) views on the efforts of state tax collectors to extend use sales and tax collection obligations to retailers who are located outside of their states and who have no physical presence in that state. The DMA is the largest trade association for businesses interested in direct marketing to consumers and businesses via catalogs, the Internet, telephone, and direct TV and radio. Founded in 1917, the DMA today has over 3,100 member companies in the United States and 53 foreign countries.

I would like to discuss specifically two initiatives that states are taking to require remote (out-of-state) sellers to become unpaid tax collectors for them: the Streamlined Sales and Use Tax Agreement (SSUTA) and advertising-based (or click-through) nexus taxes. The U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), ruled that without specific authorization from the U.S. Congress, states could not impose tax collection burdens upon remote sellers that have no "physical presence" as this would interfere with interstate commerce. Moreover, if allowed by Congress, the myriad of state tax jurisdictions with resulting variance in rates, definitions, and audits would create a complex and administratively costly nationwide sales tax collection system. It is significant that these remote sellers' businesses do not receive police or fire protection from those states—they are not present in them. Their employees and their families do not receive educational or social services from those states—the businesses have no employees located in those states.

The revenue estimates of uncollected sales and use taxes due to remote sales are grossly exaggerated. Governments, as well as businesses, face difficult financial decisions in these economic times. State legislatures have very difficult budget determinations and are looking at both cutting costs and increasing revenues. The proponents of both the SSUTA and the advertising-based nexus tax began citing a 2000 University of Tennessee study, which includes unbelievable estimates as to the amount of the uncollected sales tax. The Tennessee study estimate for uncollected sales tax due to the Internet sales in

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2006 was a whopping $45 billion nationally. A revised Tennessee study lowered those estimates to $24 billion. Even the revised estimates will not be realized.

In particular, the Tennessee study rests on a number of faulty assumptions and is not based on U.S. Government data. Further, the study's implication that states are "losing" a substantial portion of their sales tax revenues to electronic commerce is simply false. The vast majority of e-commerce transactions are not with consumers, but rather with businesses, and such business transactions almost always are subject to tax collection or direct payment of use taxes by the purchaser.

In contrast, the independent firm, Forrester Research, has estimated that the loss of tax revenue due to state residents not paying use taxes for remote sales is $3 billion nationwide—a fraction of the $24 billion estimated in the revised Tennessee study. A 2007 updated DMA-commissioned study, based on U.S. Commerce Department data, estimates that in 2006 uncollected sales tax nationally totaled $4.2 billion. There is not $24 billion pot of gold.

Streamlined Sales and Use Tax Agreement

In light of the *Quill* decision the states began a project to simplify the sale tax regimes that a remote seller would face if required to become the foreign state's tax collector. The SSUTA goal was to remove that complexity and create a 21st century, Internet-friendly tax regime to encourage economic growth throughout the national market place. The SSUTA has failed to either remove complexity or create that 21st century tax policy standard. To be blunt, the SSUTA is a document drafted by tax administrators, and, as might be expected, it resulted in little in the way of tax simplification.

Specifically, the SSUTA:

- Has not reduced the number of sales tax jurisdictions in the Nation, which currently number over 7,000;
- Has not reduced the number of state and local sales tax rates;
- Has not reduced the number of audits to which an interstate seller would be subject (each state revenue department would still conduct its own independent audit);
- Has not established a long-promised uniform vendor compensation to cover the substantial cost of tax collection; or
- Has not established a single remittance procedure.

Moreover, the Governing Board of SSUTA has granted exceptions to its feeble simplification initiatives to win approval of the states. Recently, the Board granted an exception from the SSUTA-defined rule for Massachusetts when calculating the sales tax on articles of clothing over $100. SSUTA will continue to grant exceptions which will increase complexity of sales tax collection. States are enacting sales tax holidays—some for all purchases under a capped price; others for specific products (such as hurricane preparedness) on a specific date. Those actions, while important for the state and its

citizens, further complicate a nationwide sales tax collection regime. As you can see, since the inception of SSUTA tax collection has not been simplified. SSUTA is "streamlined" in name only.

To better appreciate the failings of the SSUTA, it is instructive to consider its history. The Streamlined Sales Tax Project was launched in 2000 on the heels of two earlier joint government/industry initiatives: the National Tax Association (NTA) Communications and Electronic Commerce Tax Project, and the Congressionally-established Advisory Commission on Electronic Commerce. Both projects had concluded that the existing state sales tax system was one of daunting complexity, and that true simplification would require sweeping reforms.

Perhaps most emblematic of the SSUTA's failure to achieve genuine sales tax reform was the early demise of the single most important step toward simplification: the adoption of a single sales tax rate per state for all commerce (both over-the-counter sales and interstate sales). Had the SSUTA adopted this so-called "one rate per state" proposal, by this single act alone the SSUTA could have eliminated the problem of merchant compliance with thousands of local tax jurisdictions with different tax rates.

To put this "one rate per state" issue in perspective, the United States is the only economically developed country in the world with a system of sub-state transaction taxes, not only for counties and municipalities, but also for school districts, transportation districts, sanitation districts, sports arena districts, and other local jurisdictions. In light of this wildly complex system, the adoption of the "one rate per state" standard was the **unanimous** recommendation of the NTA's E-Commerce Project (which included delegates of the National Conference of State Legislatures, National Governors Association, and US Conference of Mayors) and was in the majority report recommendation of the Congressional Advisory Commission.

Those failings increase the burden on out-of-state sellers. Being subject to 45 separate state audits requires a tax department. Those businesses would be required to have multiple state registrations and multiple remittance procedures. The cost stemming from tax collection would be passed to consumers which would be an anti-stimulus at a time when our nation is working to stimulate the economy.

Advertising Nexus

The SSUTA affects in-state businesses that sell remotely across the nation. The added expense to those in-state businesses is one of the reasons that many states have not joined SSUTA. That failure of SSUTA to truly simplify nationwide sales tax collection has led several states to examine exotic ways to define nexus to avoid the physical presence requirement of the *Quill* decision. Some states are attempting to circumvent *Quill* by simply redefining nexus—physical presence in the state—to include any advertising agreement between a remote seller and an in-state resident wherein the resident would "link" to his website to the website of the remote seller for a commission.

Thus, if a conservation group or youth organization placed a link on its website that enables members to make purchases from an out-of-state mail order or Internet company, and the organization receives some form of consideration for agreeing to the link on its website, on those facts alone, the remote seller would be deemed to be "engaging in business" in the organization's state with all of the tax obligations associated with that status. Unilaterally expanding tax jurisdiction across state borders to businesses with no physical presence in the state is a clear violation of the bright-line test established by *Quill* and will only be a deterrent to Internet commerce.

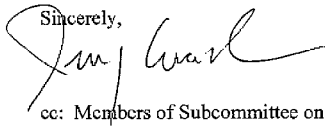
New York was the first state to implement an advertising nexus tax to help close budget shortfalls. A number of major Internet retailer immediately severed all website linking agreements with New York residents, resulting in a loss of income for New York residents and tax revenue for the state. While New York did interpret the new advertising nexus tax to not apply if the its resident's actions were completely passive, the interpretation is less helpful than it would seem since a separate fact-based analysis would be required in each case. Rhode Island and North Carolina have followed the New York example without the "passive" exemption. Neither state has received anticipated remittances from the tax since most remote sellers have severed ties for any website linking.

The result is exactly opposite of what our Nation needs in these economic times. It is a lose-lose proposition—in-state residents will lose income and pay less taxes and the remote seller will have less business and create fewer jobs. The economic engine called the Internet will have to shift into a lower gear. We need the Internet and Web-based marketing to be in high gear creating new jobs and lowering unemployment.

Congress should not expand nexus or grant the States authority to do so. Federalism does not work efficiently—or fairly—when a legislature attempts to export its tax laws across state borders. A system in which 50 state governments, and thousands of localities, impose their myriad sales and use tax regimes on businesses in each of the other 49 states would be chaotic, both as a matter of tax administration and business compliance. The end result of expanded nexus will be nothing less than a crazy quilt of non-uniform tax laws and compliance obligations that will further stagnate the consumer sector of the economy and aggravate an already grossly inefficient system of multi-state tax administration. In addition, the new tax obligations on consumer transactions will be confusing to—and burdensome for—American citizens.

DMA urges Congress not to overturn the physical nexus standard of *Quill* and not to extend the taxing authority of states beyond their borders since the Streamlined Sales and Use Tax Agreement does not streamline.

Sincerely,



cc: Members of Subcommittee on Commercial and Administrative Law

LETTER FROM THE DIRECT MARKETING ASSOCIATION (DMA)

February 3, 2010

The Honorable Steve Cohen
House Judiciary Subcommittee on
Commercial and Administrative Law
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Cohen:

The House Judiciary Subcommittee on Commercial and Administrative Law has scheduled a hearing for Thursday, February 4, 2010, on the role of Congress in defining nexus for state taxation. We understand that the hearing will address the Streamlined Sales Tax, which is of particular interest to Target.

Target is a 62 billion dollar corporation with over 350,000 team members located in 49 states. Target has a long established dot com that has grown with the rapid expansion of internet commerce. As a multi state retailer with brick and mortar stores as well as an internet entity Target collects state and local sales tax where applicable. However, retailers without brick and mortar stores are deemed not to have nexus under the Supreme Court Quill decision. These retailers sell to customers that do have an obligation to pay sales tax on goods purchased over the internet but seldom do so. This gives a significant competitive advantage to internet retailers who have no stores and a loss of tax revenue to state and local governments who depend on sales tax for basic services.

Today, 23 states have joined the Streamlined Sales and Use Tax Agreement, and with Congressional consent, these states could begin to collect the sales taxes already due and owed by out-of-state vendors. Congressman Bill Delahunt has been a champion of legislation to provide the necessary consent and level the playing field for the nation's Main Street businesses.

This legislation is all the more important in the current economic environment with states across the nation facing crippling fiscal situations. Consent to the 23 states participating in the Streamlines Sales and Use Tax Agreement would enable these states to collect the taxes they are already owed under a simplified system, supported by the retail industry. Most importantly, it would enable them to avoid having to impose new taxes or cut vital public services. And, this fiscal assistance to the states can be achieved with no cost to the federal government.

We urge you to attend the Subcommittee hearing on February 4th and raise the streamlined sales tax issue with the witnesses and the Subcommittee members. In addition, we ask you to support Congressman Delahunt's legislation and call on the Committee leaders to move this legislation forward to achieve fairness for Main Street merchants and provide critical assistance to our state and local governments.

Thank you for your consideration of this request.

Sincerely,

Nate K. Garvis
Vice President, Government Affairs &
Sr. Public Affairs Officer

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