BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2011

HEARING

BEFORE THE

SUBCOMMITTEE ON COURTS, COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

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ON

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BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2011

WEDNESDAY, APRIL 13, 2011

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

The Subcommittee met, pursuant to call, at 1:34 p.m., in room 2141, Rayburn Office Building, the Honorable Howard Coble (Chairman of the Subcommittee) presiding.

Present: Representatives Coble, Gowdy, Gallegly, Franks, Cohen, Watt, Quigley and Conyers.

Staff present: (Majority) Travis Norton, Counsel; John Hilton, Counsel; John Mautz, Counsel; Allison Rose, Professional Staff Member; Ashley Lewis, Clerk; (Minority) James Park, Subcommittee Chief Counsel; Norberto Salinas, Counsel; and Ann Woods Hawks, Professional Staff Member.

Mr. COBLE. The Subcommittee will come to order.

We have two panels today. The first includes two long time friends from the—from my neighbor to the north, Virginia, Representative Bob Goodlatte who represents the Roanoke area, and the Valley, I presume, Bob. And Representative Bobby Scott who represents the Tidewater area, primarily. Good to have both of you here.

I know Mr. Goodlatte—good to see you, Mr. Cohen.

Mr. COHEN. Good to be seen.

Mr. COBLE. Mr. Goodlatte I know has embraced this along with Representative Boucher when he was here, and now Mr. Scott has taken up the case so we have two formidable allies before us. We will be glad to recognize each one of you for 5 minutes, if possible.

Mr. Goodlatte, we'll start with you.

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

Mr. GOODLATTE. Mr. Chairman, thank you very much and Ranking Member Cohen and Members of the Subcommittee. I appreciate being invited to testify today about the "Business Activity Tax Simplification Act" which I introduced with my friend and Virginia colleague, Representative Scott.

This legislation will provide a "bright line" test to clarify state and local authority to collect business activity taxes from out of state entities. Many states and some local governments levy cor-

porate income, franchise and other taxes on out-of-state companies that conduct business activities within their jurisdictions. While providing revenue for states, these taxes also serve to pay for the privilege of doing business in a state.

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

Over the past several years a growing number of jurisdictions have sought to collect business activity taxes from businesses located in other states, even though those businesses received no appreciable benefits from the taxing jurisdiction. This has led to unfairness and uncertainty, generated contentious, widespread litigation and hindered business expansion as businesses shy away from expanding their presence in other states for fear of exposure to unfair tax burdens.

We need a basic, fair, bright line rule in this area. Previous actions by the Supreme Court and Congress have laid the groundwork for such a bright line rule. In the landmark case of Quill Corporation versus North Dakota, the Supreme Court declared that a state cannot impose a tax on an out-of-state business unless that business has a "substantial nexus" with the taxing state. However, the Court did not define what constituted a "substantial nexus" for purposes of imposing business activity taxes.

In addition, over 50 years ago Congress passed Public Law 86272 which set clear, uniform standards for when states could and could not impose certain taxes on out-of-state businesses when the businesses activities in the state were nominal and only involved the solicitation of orders for sales of tangible property. However, the scope of Public Law 86272 only extended to activities related to tangible personal property. Our Nation's economy has changed dramatically over the last 50 years and this outdated statute needs to be modernized.

The Business Activity Tax Simplification Act updates the protections of Public Law 86272 to reflect the changing nature of our economy by expanding the scope of those protections from just tangible property to include intangible property and services.

In addition, our legislation establishes a clear, uniform physical presence test such that an out-of-state company must have a physical presence in a state before the state can impose corporate net income taxes and other types of business activity taxes on that company.

In our current challenging economic times, it is especially important to eliminate artificial government-imposed barriers to small businesses. Small businesses are crucial to our economy and account for a significant majority of new product ideas and innovation. Small businesses are also central to the American dream of self-improvement and individual achievement which is why it is so vital that Congress enact legislation that reduces the excessive and often duplicative tax burdens that hinder small businesses and ultimately overall economic growth and job creation.

Unfortunately small businesses are often the hardest hit when aggressive states and localities impose excessive tax burdens on out-of-state companies. These businesses do not have the resources to hire the teams of lawyers that many large corporations devote to tax compliance and they are more likely to halt expansion to avoid uncertain tax obligations and litigation expenses.

The clarity that the Business Activity Tax Simplification Act will bring will ensure fairness, immunize litigation and create the kind of—minimize litigation and create the kind of legally certain and stable business climate that frees up funds for businesses of all sizes to make investments, expand interstate commerce, grow the economy and create new jobs.

At the same time, and it's important to emphasize, this legislation will protect the ability of states to ensure that they are fairly compensated when they provide services to businesses that do have physical presences in the state. In addition, the legislation expressly protects the ability of states to use all tools at their disposal to aggressively combat illegal activities, sham transactions and other abuses.

Thank you again for the opportunity to speak to the Committee today.

[The prepared statement of Mr. Goodlatte follows:]

TESTIMONY OF CONGRESSMAN BOB GOODLATTE
SUBCOMMITTEE ON COURTS, COMMERCIAL AND ADMINISTRATIVE LAW
HEARING ON THE
"BUSINESS ACTIVITY TAX SIMPLIFICATION ACT"
APRIL 13, 2011

Chairman Coble, Ranking Member Cohen and members of the Subcommittee, thank you for inviting me to testify today about the Business Activity Tax Simplification Act, which I introduced with my friend and colleague Representative Bobby Scott of Virginia. This legislation will provide a "bright line" test to clarify state and local authority to collect business activity taxes from out-of-state entities.

Many states and some local governments levy corporate income, franchise and other taxes on out-of-state companies that conduct business activities within their jurisdictions. While providing revenue for states, these taxes also serve to pay for the privilege of doing business in a state.

However, with the growth of the Internet, companies are increasingly able to conduct transactions without the constraint of geopolitical boundaries. The growth of the technology industry and interstate business-to-business and business-to-consumer transactions raise questions over where multi-state companies should be required to pay corporate income and other business activity taxes.

Over the past several years, a growing number of jurisdictions have sought to collect business activity taxes from businesses located in other states, even though those businesses receive no appreciable benefits from the taxing jurisdiction. This has led to unfairness and uncertainty, generated contentious, widespread litigation, and hindered business expansion, as businesses shy away from expanding their presence in other states for fear of exposure to unfair tax burdens.

We need a basic, fair, bright line rule in this area. Previous actions by the Supreme Court and Congress have laid the groundwork for such a "bright line" rule. In the landmark case of Quill Corp. v. North Dakota, the Supreme Court declared that a state cannot impose a tax on an out-of-state business unless that business has a "substantial nexus" with the taxing state. However, the Court did not define what constituted a "substantial nexus" for purposes of imposing business activity taxes.

In addition, over fifty years ago, Congress passed Public Law 86-272, which set clear, uniform standards for when states could and could not impose certain taxes on out-of-state businesses when the businesses' activities in the state were nominal and only involved the solicitation of orders for sales of tangible property. However, the scope of Public Law 86-272 only extended to activities related to tangible personal property. Our nation's economy has changed dramatically over the past fifty years, and this outdated statute needs to be modernized.

The Business Activity Tax Simplification Act updates the protections in P.L. 86-272 to reflect the changing nature of our economy by expanding the scope of those protections from just tangible personal property to include intangible property and services.

In addition, our legislation establishes a clear, uniform "physical presence" test such that an out-of-state company must have a physical presence in a state before the state can impose corporate net income taxes and other types of business activity taxes on that company.

In our current, challenging economic times, it is especially important to eliminate artificial, government-imposed barriers to small businesses. Small businesses are crucial to our economy and account for a significant majority of new product ideas and innovation. Small businesses are also central to the American dream of self-improvement and individual achievement, which is why it is so vital that Congress enact legislation that reduces the tax burdens that hinder small businesses and ultimately overall economic growth and job creation.

Unfortunately, small businesses are often the hardest hit when aggressive states and localities impose excessive tax burdens on out-of-state companies. These businesses do not have the resources to hire the teams of lawyers that many large corporations devote to tax compliance, and they are more likely to halt expansion to avoid uncertain tax obligations and litigation expenses.

The clarity that the Business Activity Tax Simplification Act will bring will ensure fairness, minimize litigation, and create the kind of legally certain and stable business climate that frees up funds for businesses of all sizes to make investments, expand interstate commerce, grow the economy and create new jobs.

At the same time, this legislation will protect the ability of states to ensure that they are fairly compensated when they provide services to businesses that do have physical presences in the state. In addition, the legislation expressly protects the ability of states to use all tools at their disposal to aggressively combat illegal activities, sham transactions, or any other abuses.

Thank you and I look forward to any questions you may have.

Mr. COBLE. Thank you, Mr. Goodlatte.

And Mr. Scott, if you will suspend just a moment. The Chair wants to recognize the presence of Dan Freeman who served a long time as parliamentarian for the House Judiciary Committee. Good to have you with us, Dan.

And now I'm pleased to recognize the distinguished—the other distinguished gentleman from Virginia, Mr. Bobby Scott.

TESTIMONY OF THE HONORABLE ROBERT C. "BOBBY" SCOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. SCOTT. Thank you, Chairman Coble, Ranking Member Cohen, Chairman—former Chairman Conyers and other Members of the Committee.

I appreciate your holding today's hearing on the Business Activity Tax Simplification Act introduced by my colleague from Virginia, Bob Goodlatte and for providing me the opportunity to testify in support of the legislation.

Business Activity Simplification Act or BATSA has attracted strong bipartisan support over the last several Congresses and I expect this version to attract the same amount of support.

BATSA seeks to update a 50-year-old Federal statute that determines when states can impose state income taxes on the sale of tangible personal good in the state—over the years states have adopted a series of business activity taxes that are proxies for state income tax, including gross receipts taxes, licensing arrangements and other changes—and other charges that states frequently seek to impose on out-of-state companies.

Some states have enacted overly aggressive and often unfair business activity taxes. Businesses in my state have been acutely affected by these aggressive business activity taxes. Smithfield Foods, located in Congressman Forbes' district, has had its trucks threatened with confiscation by New Jersey tax revenue agents simply for driving down the New Jersey Turnpike. Virginia based Capital One has joined other financial institutions in becoming easy prey for other states and localities seeking to increase their tax revenues by targeting out-of-state businesses. Other sectors of the Virginia economy, such as manufacturing, information technology, franchising, media industries all have been targeted with overly aggressive business activity taxes in other states.

There is an urgent need to modernize this decades-old law. BATSA would clarify the standard governing state assessment of corporate income taxes and comparable taxes on businesses. Specifically, the bill will articulate a "bright line" physical presence nexus standard that includes either owning or leasing real or tangible property in the state or assigning one or more employees to perform certain activities in the state for more than 15 days in a taxable year.

No one is arguing that the business should not be responsible for paying taxes where they do business. However, BATSA would ensure fairness, minimize costly litigation for both state governments and taxpayers, reduce the likelihood of a business being double taxed on the same income, and create the kind of legal certainty and stability for business environment that encourages businesses to make investments, expand interstate commerce and create new jobs.

More importantly, the bill would unsure that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections.

I appreciate the Subcommittee's focus on this timely matter and look forward to working with you as we pass this important legislation, hopefully during this session of Congress.

[The prepared statement of Mr. Scott follows:]

Statement of Congressman Robert C. "Bobby" Scott
Before the Committee on the Judiciary
Subcommittee on Courts, Commercial and Administrative Law
Hearing on H.R. 1439,
The Business Activity Tax Simplification Act of 2011
Wednesday, April 13, 2011

Chairman Coble, Ranking Member Cohen, I appreciate you holding today's hearing on the Business Activity Tax Simplification Act introduced by my Virginia colleague Bob Goodlatte, and for providing me the opportunity to testify in support of this legislation.

The Business Activity Simplification Act or BATSA has attracted strong bipartisan support over the last several Congresses, and I suspect the version introduced in this Congress will attract the same amount of support.

BATSA seeks to update a 50 year old federal statute (Public Law 86-272) that determines when states can impose state income taxes on the sale of tangible personal goods in that state.

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

Businesses in my state have been acutely affected by these aggressive business activity taxes. Smithfield Foods, located in Congressman Randy Forbes' district, has had its trucks threatened with confiscation by New Jersey tax revenue agents. Virginia based Capital One has joined other financial institutions in becoming easy prey for other states and localities seeking to increase their tax revenues by targeting out of state businesses. Other sectors of the Virginia economy, such as manufacturing, information technology, franchising, and media industries, have also been targeted with overly aggressive business activity taxes by other states.

There is an urgent need to modernize this decades old law. BATSA would clarify the standard governing state assessment of corporate income taxes and comparable taxes on a business. Specifically, the bill would articulate a bright-line physical presence nexus standard that includes either owning or leasing any real or tangible property in the state or assigning one or more employees to perform certain activities in the state for more than fifteen days in a taxable year.

No one is arguing that businesses should not be responsible for paying taxes to states where they do business. However, BATSA would ensure fairness, minimize costly litigation for both state governments and taxpayers, reduce the likelihood of a business being "double-taxed" on the same income, and create the kind of legally certain and stable business environment that encourages businesses to make investments, expand interstate commerce and

create new jobs. Most importantly, the bill would ensure that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections.

I appreciate the Subcommittee's focus on this timely matter and I look forward to working with each of you to pass this important bill in this session of Congress. Thank you.

Mr. COBLE. I thank each of you for being with us. We normally don't examine Members, so I assume does anyone have questions for the Members? We usually—gentleman from Illinois?

Mr. QUIGLEY. Just for a point of clarification, how would you two gentlemen distinguish most of the taxes you're talking about that, as you say, could be very burdensome just for driving down the New Jersey Turnpike, for example, and the much more controver-

sial aspect of the transaction tax dealing with the Internet and how some states and local governments are reacting to the fact that their retailers are closing down because so much more of those sales are taking place on the Internet and the shortfall that it is creating?

Mr. GOODLATTE. Well, if the gentleman would allow? This legislation is neutral as between bricks and mortar entities and online entities. You'll find pretty much widespread business support from both groups.

As you know, with relation to sales taxes online, there's a great division there between those who do business within an individual state and required by state law, because they do have that nexus with the state, and entities that operate from a greater distance.

This does not address that issue in any way, shape or form. It would not limit the ability of the Congress to change the—as you know, right now the Congress has never provided the necessary finding of nexus to allow a state to require a company in another state to collect sales taxes. They're left with having to try to collect that from the individual who owes the tax and that of course is a too burdensome way to collect it.

Some of us have suggested that the states should work together to come up with a single definition of what is taxable and perhaps even a single interstate sales tax so that if you're a small business doing business online, you're not talking about having to know the tax in not just 50 states but thousands of sub-jurisdictions that have add on sales taxes. So that is a separate, complicated issue and is not addressed here.

Mr. QUIGLEY. Thank you. I yield back.

Mr. COBLE. Any other questions for the Members?

Mr. Cohen?

Mr. COHEN. Since we have two fine gentlemen from the Commonwealth, I'd like to ask you what you think Mr. Jefferson would think of this bill and why.

Mr. SCOTT. He would think—I think he would like the bill. It's a fine piece—— [Laughter.]

Mr. COHEN. Great answer.

Mr. COBLE. Mr. Cohen, you asked for that one.

Gentlemen, good to have both of you with us.

Trey, did you have any questions?

Mr. GOWDY. No, sir, Mr. Chairman.

Mr. COBLE. You're excused, gentlemen. Good to be—good to have you with us.

I'll give my opening statement and then I'll recognize Mr. Cohen and Mr. Conyers after that and then we'll proceed with our other panel.

Benjamin Franklin once remarked that nothing is certain in this world except death and taxes. But while taxes are necessary to fund the essential government operations, they should not be imposed arbitrarily or unfairly, especially on America's small businesses which create the majority of jobs in this country.

The Dormant Commerce Clause prohibits states from imposing taxes on entities that lack a substantial nexus to the taxing state. In the 1922—strike that. In the 1992 Quill decision, the Supreme Court held that a state could not impose a sales or use tax on a

business that was not physically present in the taxing state. Since then some courts have held that the physical presence standard does not apply to the imposition of net income or other business activity taxes.

As a result, each state's standard for what constitutes substantial nexus for net income taxes varies. Some states like Texas and Tennessee hold that the physical presence standard applies, but the majority of states allow taxation of net income if there is merely an economic nexus between the state and the taxpayer.

Some businesses are thus faced with a lose/lose situation. They may hire expensive accountants and tax attorneys to decipher the tax laws of the states in which they transact business to determine whether they have tax liability, but most small businesses lack the resources to do this. Those that do find such resources pass the cost on to the consumers in the form of higher priced goods and services. Our small businesses can reasonably conclude that they are not liable to pay taxes in a state because they transact only very limited business there, but under this approach, if a state later concludes that taxes should have been paid, the business will owe—likely will owe penalties in addition to back taxes.

In my opinion, there's a substantial need for a clear rule for what a state may impose in net income or other business activity tax. H.R. 1439, the Business Activity Tax Simplification Act of 2011, does just that. It clarifies that a state may not impose such a tax on a business that lacks physical presence in the state.

BATSA also updates a law Congress passed in 1959 which prohibits states from taxing businesses merely because they employ salesmen who travel to the states selling tangible goods. That was 52 years ago. In the modern American economy services and intangible goods play a significant and larger role than they did in 1959. There's no good reason, it seems to me, to discriminate between tangible and intangible goods in this regard, so we ought to update that law.

It is important to note that BATSA does not require states or localities to reduce their taxes, rather it gives small businesses some certainty about their tax liability so they can adequately budget their resources, and to the extent possible, create more jobs.

This is not the first time this Committee has considered BATSA, but state taxation is an important issue and I am pleased to take it up once again.

Again, we thank Mr. Goodlatte and Mr. Scott for having been with us. And I am now pleased to recognize the distinguished gentleman from Tennessee, Mr. Steve Cohen, the Ranking Member.

[The bill, H.R. 1439, follows:]

I

112TH CONGRESS
1ST SESSION

H. R. 1439

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

IN THE HOUSE OF REPRESENTATIVES

APRIL 8, 2011

Mr. GOODLATTE (for himself, Mr. SCOTT of Virginia, Mr. DUNCAN of South Carolina, and Ms. JACKSON LEE of Texas) introduced the following bill; which was referred to the Committee on the Judiciary

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A BILL

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

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "Business Activity Tax Simplification Act of 2011".

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

(a) SOLICITATIONS WITH RESPECT TO SALES AND TRANSACTIONS OF OTHER THAN TANGIBLE PERSONAL PROPERTY.—Section 101 of the Act entitled "An Act relating to the power of the States to impose net income

1 taxes on income derived from interstate commerce, and
2 authorizing studies by congressional committees of mat-
3 ters pertaining thereto", approved September 14, 1959
4 (15 U.S.C. 381 et seq.), is amended—
5 (1) in section (a), by striking "either, or both,"
6 and inserting "any one or more";
7 (2) in subsection (a)(1), by striking "by such
8 person" and all that follows and inserting "(which
9 are sent outside the State for approval or rejection)
10 or customers by such person, or his representative,
11 in such State for sales or transactions, which are—
12 "(A) in the case of tangible personal prop-
13 erty, filled by shipment or delivery from a point
14 outside the State; and
15 "(B) in the case of all other forms of prop-
16 erty, services, and other transactions, fulfilled
17 or distributed from a point outside the State;";
18 (3) in subsection (a)(2), by striking the period
19 at the end and inserting a semicolon;
20 (4) in subsection (a), by adding at the end the
21 following new paragraphs:
22 "(3) the furnishing of information to customers
23 or affiliates in such State, or the coverage of events
24 or other gathering of information in such State by
25 such person, or his representative, which information

is used or disseminated from a point outside the State; and

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

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

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

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

"(2) by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State are limited to making sales or fulfilling transactions, soliciting order for sales or transactions, the furnishing of information to customers

or affiliates, and/or the coverage of events or other gathering of information; or

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

(6) in subsection (d)(1)—

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

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

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

"SEC. 105. For taxable periods beginning on or after January 1, 2012, the prohibitions of section 101 that apply with respect to net income taxes shall also apply

with respect to each other business activity tax, as defined in section 5(a)(2) of the Business Activity Tax Simplification Act of 2011. A State or political subdivision thereof may not assess or collect any tax which by reason of this section the State or political subdivision may not impose.''.

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

(a) IN GENERAL.—No taxing authority of a State shall have power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person's activities in interstate commerce unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed.

(b) REQUIREMENTS FOR PHYSICAL PRESENCE.—

(1) IN GENERAL.—For purposes of subsection (a), a person has a physical presence in a State only if such person's business activities in the State include any of the following during such person's taxable year:

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

1 (B) Using the services of an agent (exclud-
2 ing an employee) to establish or maintain the
3 market in the State, if such agent does not per-
4 form business services in the State for any
5 other person during such taxable year.
6 (C) The leasing or owning of tangible per-
7 sonal property or of real property in the State.
8 (2) DE MINIMIS PHYSICAL PRESENCE.—For
9 purposes of this section, the term "physical pres-
10 ence" shall not include—
11 (A) presence in a State for less than 15
12 days in a taxable year (or a greater number of
13 days if provided by State law); or
14 (B) presence in a State to conduct limited
15 or transient business activity.
16 (c) TAXABLE PERIODS NOT CONSISTING OF A
17 YEAR.—If the taxable period for which the tax is imposed
18 is not a year, then any requirements expressed in days
19 for establishing physical presence under this Act shall be
20 adjusted pro rata accordingly.
21 (d) MINIMUM JURISDICTIONAL STANDARD.—This
22 section provides for minimum jurisdictional standards and
23 shall not be construed to modify, affect, or supersede the
24 authority of a State or any other provision of Federal law

allowing persons to conduct greater activities without the imposition of tax jurisdiction.

(e) EXCEPTIONS.—

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

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

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

(2) TAXATION OF PARTNERS AND SIMILAR PERSONS.—This section shall not be construed to modify or affect any State business activity tax liability of an owner or beneficiary of an entity that is a partnership, an S corporation (as defined in section 1361 of the Internal Revenue Code of 1986), a limited liability company (classified as a partnership for Federal income tax purposes), a trust, an estate, or any other similar entity, if the entity has a physical presence in the State in which the tax is imposed.

(3) PRESERVATION OF AUTHORITY.—This section shall not be construed to modify, affect, or supersede the authority of a State to enact a law and bring an enforcement action under such law or existing law against a person or persons or an entity or entities, including but not limited to related persons or entities, that is or are engaged in an illegal activity, a sham transaction, or an actual abuse in its or their business activities in order to ensure a proper reflection of its or their tax liabilities, nor shall it supersede the authority of a State to require combined reporting.

SEC. 4. GROUP RETURNS.

If, in computing the net income tax or other business activity tax liability of a person for a taxable year, the net income or other economic results of affiliated persons is taken into account, the portion of such combined or consolidated net income or other economic results that may be subject to tax by the State shall be computed using the methodology that is generally applicable to businesses conducting similar business activities and, if that generally applicable methodology employs an apportionment formula, the denominator or denominators of that formula shall include the aggregate factors of all persons whose net income or other economic results are included in such

combined or consolidated net income or other economic results and the numerator or numerators shall include the factors attributable to the state of only those persons that are themselves subject to taxation by the State pursuant to the provisions of this Act and subject to all other legal constraints on State taxation of interstate or foreign commerce.

SEC. 5. DEFINITIONS AND EFFECTIVE DATE.

(a) DEFINITIONS.—For purposes of this Act:

(1) NET INCOME TAX.—The term "net income tax" has the meaning given that term for the purposes of the Act entitled "An Act relating to the power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto", approved September 14, 1959 (15 U.S.C. 381 et seq.).

(2) OTHER BUSINESS ACTIVITY TAX.—

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

(B) EXCLUSION.—The term "other business activity tax" does not include a sales tax,

a use tax, or a similar transaction tax, imposed on the sale or acquisition of goods or services, whether or not denominated a tax imposed on the privilege of doing business.

(3) PERSON.—The term "person" has the meaning given such term by section 1 of title 1 of the United States Code. Each corporation that is a member of a group of affiliated corporations, whether unitary or not, is itself a separate "person."

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

(5) TANGIBLE PERSONAL PROPERTY.—For purposes of section 3(b)(1)(C), the leasing or owning of tangible personal property does not include the leasing or licensing of computer software.

(b) EFFECTIVE DATE.—This Act shall apply with respect to taxable periods beginning on or after January 1, 2012.

○

Mr. COHEN. Thank you, Mr. Chairman. Three years ago the subcommittee on Commercial and Administrative law held a hearing on legislation substantially similar to this bill, H.R. 1439, the "Business Activity Tax Simplification Act of 2011." At that time I noted the issues that BATSA was trying to address were complex ones. What should be the proper scope of a state's authority to impose a corporate income tax or other similar tax on a particular company based on the company's business activity in that state? What role should Congress play in defining that scope? And those were the primary issues.

The constitution requires a sufficient nexus to exist between a state and a business' in-state activity in order for that state to be able to tax that business. The Supreme Court, however, has been ambiguous as to what that nexus is in the business activity tax context.

In 2008 I heard what I thought were some valid concerns expressed about the adoption of a physical presence standard as the only determinative of whether a given business had sufficient nexus with a state for business activity tax purposes. I also called upon interested stakeholders to use the bill's introduction as an opportunity to reach a consensus on a clear and uniform national standard for state taxation of business activity. Unfortunately that does not seem to be what has occurred in the intervening time. So here we are.

I agree with proponents of H.R. 1439 that a uniform national standard that determines when a state can tax business activity will provide useful clarity and reduce the cost of doing business. But by expanding the limitations on taxable business activity under Federal law, and by once again adopting physical presence in a state as the sole basis for what a state tax business activity, I am concerned that H.R. 1439, if enacted would cost states to potentially lose billions of dollars in tax revenue that they should be entitled to. This revenue loss in turn threatens to undermine critical state and local government services and adversely impact employees.

The physical presence standard concerns me, because it appears to be too restrictive, does not fully capture business activity that a state legitimately, constantly should be able to tax. Adoption of the physical presence standard threatens to prohibit taxation of activities that currently states can tax.

The standard limits the scope of a state's authority to impose a corporate income tax or other business activity in one of three situations. Where business is physically present in the state or is assigned one or more employees in the state. Secondly, where the business uses the service of an agent to establish or maintain the market in a state. Or, the business leases or owns tangible personal or real property in the state during the relevant tax year.

I fear that this narrowly crafted standard allows businesses simply to game the system, by for example, making all employees independent contractors or allowing banks to conduct online businesses in all states while avoiding taxes on such activity, because they lack tangible property in most states.

I feel like a TV show with background action. It's very difficult.

Worse yet, according to a Congressional Budget Office cost estimate prepared in 2006 for an earlier, but substantially similar version of BATSA, the act would concentrate 70 percent of revenue losses in just ten states. One of those states would be Michigan, home of the Wolverines. Another would be Texas. Whatever. And the other is Tennessee, that matters.

I noted that at least one alternative to physical presence as a uniform standard has been proposed by the Multistate Tax Commission. I do not take a view on the merits of that alternative proposal. I simply note that—and reiterate my point from 3 years ago, which is that while uniform standard of business activity taxes and the clarity and certainty it provides are valuable, that uniform standard must be one that is fair to all who would be impacted. H.R. 1439 does not appear to meet that goal.

With that, I yield back the remainder of my time.

Mr. COBLE. And I apologize to you, Mr. Cohen, for having talked behind your back. We had to get some preliminaries out of the way.

Mr. COHEN. It was the physical dance I had to do which was more difficult—— [Laughter.]

But there was the challenge, and I appreciate rising to their——

Mr. GOWDY. Physical presence.

Mr. COHEN [continuing]. Right, it was physical presence.

Mr. COBLE. The distinguished gentleman from South Carolina has no opening statement.

Mr. Conyers, the distinguished gentleman from Michigan is recognized for 5 minutes.

Mr. CONYERS. Thank you, Chairman Coble.

Ladies and gentleman, imposing a physical presence standard would drastically alter the taxing landscape as we know it. With respect to past legislation similar to this, surveys have estimated that lost state tax revenues might be as high as $8 billion in the first year following enactment, and that was an estimate from several years ago. The impact might be even more damaging now.

If this legislation has a similar negative impact on the states I wonder how any of us can support it. The states are already getting Federal budget cuts all over the place and now we want to make sure that we increase the stress and the dire circumstances that they find themselves in. This is legislation that might possibly eviscerate some state revenues. We would, in effect, be turning our back once again on state governments. We would be forcing state governments to eliminate valuable governmental programs and services and furlough dedicated government workers, some are already doing it. We should shudder at the impact of a potential loss of $8 billion on top of the lost tax revenue base the states have suffered in the last few years.

I don't know if there is support enough to pass a legislative measure which would undercut states' abilities to tax activity within its borders. In this case, Congress should not step in and impose a damaging physical presence standard for activities which a state may have the constitutional right already to tax.

An $8 billion loss to the states which have already suffered extensively during this economic downturn, would further hamper economic—the economic rebound that people keep looking and hoping and praying will occur. And when you consider the Federal cuts

to state and local assistance, which the Ryan budget will obviously lead to, our state and local governments would be suffering, in my view unnecessarily, for years to come.

So while Congress must ensure that the states do not burden interstate commerce through their taxing authority, the authority of states to tax activity within their borders must be respected. Why not? And unfortunately the proposal that we are examining does not seem to balance these competing interests.

And with that, Chairman Coble, I return any unused time.

Mr. COBLE. I thank the gentleman.

I am told that there will be an imminent vote on the floor in a matter of minutes, but we will go ahead and start.

I will invite the witnesses, if they will assume their seated position at the table and I will introduce the witnesses.

We have a very favorable group of three panelists who will be us today.

Mr. Corey L. Schroeder is vice president and chief financial officer of Outdoor Living Brands, a multi-brand franchise company dedicated to products and services within the outdoor living market. As VP and CFO of Outdoor Living Brands, Mr. Schroeder is responsible for the financial reporting and management of the business overseeing franchise compliance matters and working to support the strategic direction of the company.

Prior to the formation of Outdoor Living Brands, Mr. Schroeder served as vice president and CFO of U.S. Structures, Inc., also a franchise company.

Mr. Schroeder holds a bachelors degree in business administration with a concentration in finance from the University of Richmond and a masters degree in accounting from the College of William and Mary. He also holds a designation of chartered financial analyst.

Our second witness is Mr. Bruce Johnson who is the Utah governor—in 2009 Utah Governor Gary Herbert appointed Bruce Johnson to serve as chairman of the Utah State Tax Commission. He has been a commissioner since 1998. The Tax Commission has the constitutional duties to administer all—and supervise all the tax laws of the state, including property tax, income tax, franchise tax, sales tax and all miscellaneous taxes.

Prior to his appointment, Mr. Johnson litigated numerous tax disputes as a private attorney and as a trial attorney for the Tax Division of the United States Department of Justice.

He's a CPA and holds a degree in accounting from the University of Utah. Mr. Johnson also served on numerous boards and testified before legislative bodies. He was, as well, the founding national co-chair of the Streamlined Sales Tax Project.

Our final witness today, Mr. Joseph Henchman. Mr. Henchman is a tax counsel and director of state projects at the Tax Foundation a nonprofit organization dedicated to educating taxpayers about all aspects of tax policy. He joined the Tax Foundation in 2005.

Mr. Henchman's analysis of fiscal trends, constitutional issues and tax law developments has been featured in numerous print and electronic media, including The New York Times, The Wall Street Journal, CNN and Fortune magazine.

Of particular relevance to this hearing, in 2007 Mr. Henchman published an article in a popular state sales periodical entitled, "Why the Quill Physical Presence Standard Should Not Go Away—Should Not Go the Way of Personal Jurisdiction."

Mr. Henchman was graduated from the University of California at Berkley with a degree in political science and a law degree from the George Washington University.

Gentlemen, good to have you with us. We operate on a 5-minute rule, gentlemen. The panel before you, the green light will expire at the conclusion of 4 minutes. And you will see an amber light then which is your notice to—if you can start wrapping up at that time we would be appreciative. And we try to apply that 5 minute rule to us as well on this side of the podium.

Mr. Schroeder, why don't you start us off?

TESTIMONY OF COREY SCHROEDER, VICE PRESIDENT AND CFO, OUTDOOR LIVING BRANDS, INC. (RICHMOND, VA), ON BEHALF OF THE INTERNATIONAL FRANCHISE ASSOCIATION

Mr. COBLE. Mr. Schroeder, I know either your mic is not on or is not close to you.

Mr. SCHROEDER. How is that?

Mr. COBLE. That's better.

Mr. SCHROEDER. Thank you. Thank you again for providing me the opportunity to voice my support for the Business Activity Tax Simplification Act of 2011. And thank you also to Congressmen Scott and Goodlatte, from my home state of Virginia, for introducing the bill.

I'm speaking today on behalf of Outdoor Living Brands located in Richmond, Virginia. We currently operate three franchise brands with 181 locations in 34 states and have 28 employees.

I'm also here today on behalf of the International Franchise Association, the largest and oldest franchising trade group representing more than 90 industries, more than 13,000 members nationwide. And according to a study done for the IFA by Price Waterhouse Coopers, there are over 825,000 franchise businesses across 300 different business lines providing nearly 18 million American jobs and generating over $2.1 trillion for the American economy.

The Business Activity Simplification Act of 2011 addresses a significant issue within the franchise community relating to state income tax reporting. Franchise businesses face a very confusing and ever changing set of rules regarding the obligation to file state corporate income taxes. The primary issue is the different and changing definitions of nexus to establish—established with various states for our business activities.

Once nexus is established we must begin filing state corporate income tax returns for that portion of our revenue that we generate from that state. Like Outdoor Living Brands, most franchisors do not own any real property in the states which our—in which our franchisees operate. We only have, in my case, a physical presence in the State of Virginia.

However, central to the concept of our business in franchising is the relationship with our franchisees and primarily our shared trade identity of our brand. We license that trade identity and that

intellectual property and business plan to local entrepreneurs, as well as support them in growing and building their business and providing jobs in their local markets and their various states.

Many states, however, now are concluding that the very existence of our brand and our intellectual property or even the physical existence of our training manuals in their states is establishing nexus. And I understand the desire for states, in this fiscal environment, to need to generate and want to generate revenue from out-of-state businesses, however, the local outcome of this view on nexus, for a company like Outdoor Living Brands, is that we would file 34 different state tax returns and less than 10 percent of our revenue would be taxed in the state of Virginia where we operate.

Franchising is already a very heavily regulated business model and my small firm spends close to $100,000 a year in legal, accounting and tax advisory fees. It does not—that does not include the time of myself or the folks on my team, and these are precious resources that we would like to be using to help grow our franchisees and our businesses.

Currently my firm files income taxes in six states. With various nexus and standard enforcement practices changing I expect the costs and administrative burden of this particular issue to continue to grow. My most recent experiences with it was with the State of South Carolina and Minnesota who both sent me business activity questionnaires. These lengthy questionnaires, to which I answered no to almost every activity described, were in the end determined that it was simply the existence of my franchise agreement and the royalty revenue derived in that state that required nexus and I had to file several years of past returns.

One state in particular, South Carolina, a South Carolina revenue agent described for me how he found our business by creating a mass mailing list of franchise companies like mine, using a marketing website service that the franchising industry it commonly uses to sell franchises.

As a franchisor I have very little visibility on what the nexus rules are in each state and when they change and why they change. And South Carolina's activity was based on a court case that happened in that state.

Iowa just recently announced a similar change due to a court case. And I expect I will be getting a questionnaire from them and I will deal with them in—as the questionnaire comes up.

And this raises the issue of managing this issue. For a small business like mine, managing this issue is rife with uncertainty created by this environment. I could proactively engage another tax advisor and have them go seek out all the 34 states where I have franchisees and determine which ones would have nexus with me. I am sure that the states would gladly agree that I have nexus. And then I could pay that tax advisor even more to continue to fill out more and more tax returns in the various states.

I could be passive, which is what I think most franchisors in my situation do, where we wait for the next franchise activity questionnaire to come in and we respond to it accordingly.

To sum up, earlier in my career I worked in investment banking and I advised a number of private businesses in a lot of different industries with far broader business activities in different states

than what we experience in franchising. And franchising is the only business I have come across where we face this level of complexity and this burden of state tax compliance.

So, I hope this testimony has been helpful in illustrating the difficulty that franchise businesses face across the country related to this. And I hope we can work together to pass the Business Activity Simplification Act.

Thank you.

[The prepared statement of Mr. Schroeder follows:]

Statement of Corey Schroeder
Vice President & CFO, Outdoor Living Brands, Inc.

Before the House Subcommittee on Courts, Commercial and Administrative Law

Hearing on H.R. 1439, the "Business Activity Tax Simplification Act of 2011"

April 13, 2011

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Statement of Corey Schroeder
Vice President & CFO, Outdoor Living Brands, Inc.

United States House of Representatives
Subcommittee on Courts, Commercial and Administrative Law

April 13, 2011

Good afternoon Chairman Coble, Ranking Member Cohen, and members of the subcommittee. My name is Corey Schroeder, and I am grateful for the opportunity to speak today in support of the *Business Activity Tax Simplification Act of 2011*, or "BATSA," and the specific impact the current state income tax reporting environment has on my company, Outdoor Living Brands and on franchise businesses in general.

I am the Vice President and Chief Financial Officer of Outdoor Living Brands, Inc., which is located in Richmond, Virginia and was formed in 2008 to acquire franchise businesses in the outdoor living category. We currently operate three brands representing 181 franchise locations in 34 states. Despite this reach, we are a small business with $4.6 million in revenue and only 28 employees.

During my remarks today, I will highlight why small businesses require a federal solution to bring greater certainty to compliance with state tax laws. I will share with you the experience of our company in navigating the unpredictable nature of state nexus decisions across multiple jurisdictions. Finally, I will provide insight into how the uncertainty of these nexus decisions impact the hundreds of thousands of franchise businesses in the United States.

Our franchise system is an active member of the International Franchise Association (IFA). As the largest and oldest franchising trade group, the IFA's mission is to safeguard the business environment for franchising worldwide. The IFA represents more than 90 industries,

including more than 11,000 franchisee, 1,100 franchisor, and 575 supplier members nationwide. According to a study conducted by PwC for the IFA Educational Foundation, there are over 825,000 franchise businesses across 300 different business lines providing for nearly 18 million American jobs and generating over $2.1 trillion to the U.S. economy.

Franchised businesses play an important role in the economic health of the U.S. economy, and they are poised to help lead the economy on the path to recovery. The IFA Educational Foundation report shows that the franchise industry consistently outperforms the non-franchised business sector, creating more jobs and economic activity in local communities across the country. Franchising grew at a faster pace than many other sectors of the economy from 2001 to 2005, expanding by more than 18 percent. During this time, franchise business output increased 40 percent, compared to 26 percent for all businesses.

The franchise model allows companies like Outdoor Living Brands to grow our business concepts in communities across the country by partnering with local entrepreneurs that invest in and operate their own small businesses. As the franchisor we provide a business concept and operating plan, a brand, licensing of intellectual property in the form of trademarks and copy writes, as well as ongoing training and operational support to our franchisees. Our objective is to serve each local community with our services and help our franchisees build successful small businesses that create jobs.

Outdoor Living Brands an Illustration

This legislation would address a significant issue within the franchising community related to state income tax reporting. The primary issue facing franchisors are the confusing and ever changing rules governing the establishment of tax nexus based on business activities in each state.

When nexus is determined to exist, a franchisor is required to file state corporate income taxes based on the apportioned earnings derived from franchisees in that state. Creating a consistent definition of what constitutes nexus would greatly simplify tax reporting obligations for franchise companies and reduce a significant area of confusion, uncertainty and administrative cost.

While Outdoor Living Brands and franchise companies like ours have franchise locations in many states we do not have operations in those states. Outdoor Living Brands is a company incorporated in the Commonwealth of Virginia. Our physical presence, the development of our brand, the development and training of new franchisees, the support of existing franchisees - everything that makes us a franchisor - takes place in Virginia. The only assets we have in the various states are our franchise agreements, the contract that governs the terms of the relationship between us and our franchisees.

Certain states through legislation or recent court rulings have begun to recognize the mere existence of these franchise agreements and the use of our intellectual property or even the physical existence of our training manuals in their states as establishing nexus. I understand the desire of state tax agencies to generate revenue from out of state businesses from the royalty and licensing revenue derived from those states, especially in the current fiscal environment. However, the logical outcome of this view is for a small company such as Outdoor Living Brands, which conducts materially all of its business in the state of Virginia, would pay less than 10% of our state corporate income taxes to Virginia. Add to this the administrative and cost burden of filing 34 state tax returns and more as we expand to new states.

As a franchise business we are already a highly regulated business. Our franchise offering is prepared in accordance with the rules set by the Federal Trade Commission. Further,

we must comply with additional rules set in certain states. We currently file a franchise tax return in Texas and we have to report on our franchisees' sales tax activity to the State of New York (a recent development). Finally, due to nexus rules we must file state income tax returns in Virginia, Ohio, North Carolina, Arizona, South Carolina, and Minnesota. The filing fees and expenses for audit, legal, and tax services approaches $100,000 per year. That does not include any allocation of my time or the time of our staff to prepare these various filings each year.

Without reform such as that provided by the *Business Activity Tax Simplification Act* the financial and administrative burden associated with tax compliance will continue to grow. This issue diverts resources vital to our business' ability to grow and support our franchisees.

Outdoor Living Brands provides an illustration of how this issue has grown in complexity in recent years. Our business has growth through the acquisition of our three brands. Through those transactions we acquired operations in Virginia, North Carolina, and Ohio. We have since ceased operations in North Carolina and Ohio but our nexus in those states remains for some reason.

Nexus with Arizona, Minnesota, and South Carolina is established purely through the existence of our franchise locations in those states. Most recently South Carolina in 2007 and Minnesota in 2008 established nexus with us through a questionnaire process. Revenue departments from those states sent Outdoor Living Brands a lengthy business activity questionnaire. After checking 'No' to almost every business activity described in the questionnaire it was determined that the existence of our franchisees was sufficient to establish nexus. We were required to file several years of past due tax returns. If we complied within a specified period of time we could have penalties and interest reduced. The South Carolina questionnaire was driven by a then recent court decision, prior to which our company did not

have nexus. I never had any awareness of the nexus with Minnesota until the questionnaire process.

Hopefully, you can see the uncertainty facing franchise businesses surrounding this issue. We do not know with which states we have nexus or why. Further, we have no effective way of determining when those rules change or why.

As a franchise executive I have several ways to manage this issue. The first is to allocate even more of my scarce financial and management resources to proactively determine nexus status with each state. Likely, I would hire a tax consultant to research the remaining twenty-seven states where we have franchisees to explore if our business activity establishes nexus. I expect the states would err on the side of establishing nexus and I will then hire that tax consultant to file tax returns in those states. As you can imagine this is not an attractive approach for a small business like ours. Alternatively, I can take a passive approach and wait until the next business activity questionnaire arrives and start the process with that state, likely adding them to my roster of state income tax filings. The last option which some small business owners have suggested is to ignore the questionnaires and hope that the states are busy enough with larger companies (or those that responded) to overlook them for a couple of years.

Impact on Larger Franchising Business Community

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 all businesses that use the franchise business model to expand their brand.

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 business community 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 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.

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 as sufficient for the establishment of an

economic, rather than a 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.

In December, the Iowa Supreme Court issued a troubling ruling in the case of KFC Corporation v. Iowa Department of Revenue. The ruling held that the U.S. Supreme Court would likely find that the intangibles that KFC licensed to its Iowa franchisees "would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of 'physical presence.'" This functional-equivalency test goes beyond related case law and is of questionable basis. The physical-presence test is a bright-line test that cannot be met through the "presence" of intangible property in a state. It is difficult to reconcile the Iowa Supreme Court's holding with this test, adding another layer of confusion for companies that are trying to properly assess their tax exposure. Such actions at the state level 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 franchising. 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

Earlier in my career, as an investment banker, I provided professional services to dozens of small businesses in as many industries with far broader business activities compared to Outdoor Living Brands. Few other businesses face the unique complexity in state tax obligations as faced by franchise businesses due to the current nexus environment. The total cost of complying with the current state income tax environment is burdensome. The rules change frequently creating a great deal of uncertainty. The reforms provided by the proposed legislation would greatly improve these conditions for the franchise industry.

I want to thank the members of the Subcommittee on Courts, Commercial and Administrative Law for the opportunity to participate in today's important hearing on the *Business Activity Tax Simplification Act*. It is my hope that we can work together to pass this legislation to address the unnecessary hardship that thousands of franchise businesses face across this country when it comes to compliance with state tax laws.

Thank you and I look forward to answering any questions you may have.

10

Mr. COBLE. Thank you, Mr. Schroeder.
Mr. Johnson?

TESTIMONY OF R. BRUCE JOHNSON, CHAIRMAN, UTAH STATE TAX COMMISSION (SALT LAKE CITY, UT), ON BEHALF OF THE FEDERATION OF TAX ADMINISTRATORS

Mr. JOHNSON. Chairman Coble, Vice Chairman Gowdy, Ranking Member Cohen and Members of the Committee, thank you for the opportunity to address this issue today. I am Bruce Johnson, chair of the Utah State Tax Commission. Today I am testifying on behalf of the Federation of Tax Administrators which is an association of tax administration agencies in each of the 50 states, the District of Columbia and New York City.

This is not a greedy states versus poor taxpayer bill. This is a bill about large multistate businesses versus small local businesses and how a state can allocate its tax base and its tax burden among the entities doing business in the state. That is what it is about. It is also a bill about Federal preemption of state sovereignty and when it is appropriate for the Federal Government to limit a state's sovereign power to raise its revenue as it sees fit through its local elected officials.

We have already heard some discussion about the estimated revenue impact of this bill. The Congressional Budget Office said it would result in a $3 billion annual revenue loss, that's the 2005 predecessor of this bill. The NGA has substantially larger estimates. But that is not revenue that is going to go away, that is revenue that is going to be shifted if we can't tax the fair share of interstate businesses that do business in our state. That tax is going to be shifted to our local businesses and our local taxpayers. It is going to have a devastating impact on small business.

The U.S. Supreme Court has held that a company meets the jurisdictional standard of substantial—or sufficient contacts if it is doing business in the state or otherwise engaged in establishing and maintaining a market in the state. This bill purports to establish a physical presence standard which has never been the law for income taxes or business activity taxes. But I suggest it is not even a physical presence standard. If you look at Public Law 86–272, which the proponents of the bill seek to expand, 86–272 allows a business to have permanent employees in a state, driving company cars on state roads, and as long as they are not engaged in activities other than the solicitation of sales, that physical presence has to be ignored and the state can't tax that business even though it clearly has physical presence there.

This bill would seek to extend that preemption not only to the solicitation of sales of tangible personal property, but to the solicitation of services, to the solicitation of sales of intangible property, to the gathering of information in a state, to the furnishing of information to customers in the state. It would say that 15 days in the state is not physical presence. That may be a reasonable de minimis test for many taxpayers, but it also says if the activity of the business, the physical presence is for a limited or transient business purpose, it can be longer than 15 days.

Now I don't know what a limited or transient business purpose is. And I don't see how that provides clarity to our taxpayers. In a multi-level company that manufacturers, distributes and retails, is a warehouse in the state just a limited purpose? It may well be under this law.

Moreover, activities of subsidiaries can easily be ignored with a little bit of structuring. I had the privilege of representing taxpayers for over 17 years and I can tell you that under the provisions of this bill I could substantially reduce the tax obligations of many taxpayers in Utah that have a physical presence through the—merely by setting up a subsidiary, a toy company could—that has a 5-percent profit margin in the state could set up an intangible holding company in Delaware, charge a 2-percent royalty and cut its taxes in Utah by 40 percent even though it continued to have a store in Utah. It could set up a 3-percent royalty and cut its taxes by 60 percent, even though it continued to have physical presence in Utah.

I acknowledge the need for more clarity. This bill unfortunately is fatally flawed in many ways and I urge you to oppose the bill. Thank you.

[The prepared statement of Mr. Johnson follows:]

STATEMENT OF

R. BRUCE JOHNSON
COMMISSIONER, UTAH STATE TAX COMMISSION

ON BEHALF OF
THE FEDERATION OF TAX ADMINISTRATORS

BEFORE THE

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

ON

H.R. 1439
THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

APRIL 13, 2011

Chairman Coble, Vice-Chairman Gowdy, Ranking Member Cohen and Members of the Subcommittee, thank you for the opportunity to address the Subcommittee concerning H.R. 1439, the Business Activity Tax Simplification Act (BATSA). I am Bruce Johnson, Commissioner of the Utah State Tax Commission. Today, I am testifying on behalf of the Federation of Tax Administrators (FTA). FTA is an association of the tax administration agencies in each of the 50 states, the District of Columbia, and New York City.

FTA strongly opposes H.R. 1439 because the bill would:

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

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

What is the effect of BATSA on state revenues?

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

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

Eight states have reported revenue loss estimates for 2010 based on the last version of this Act introduced in 2009. Due to the uncertainty of the actual revenue impact on their state, four of the responding states have provided estimates of the minimum impact and the maximum impact as well as their "best" estimate of the impact of the Act. The ranges of the annual revenue loss of the states are as follows:

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

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

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

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

How do states tax businesses now?

States levy various forms of business activity taxes today. The most common is the corporation net income tax imposed in 44 states and D.C. These taxes are similar to federal income tax, but the rates imposed are much lower than federal, with top marginal rates currently ranging from 3-12%.[1] Other types of business activity taxes that would presumably be affected by the bill include the Washington State Business and Occupation Tax, Ohio Commercial Activity Tax, Michigan Business Tax and Texas "Margin Tax." which are general business taxes levied on gross receipts (or a variant thereof) sourced to a state, as well as the New Hampshire Business Enterprise Tax (a value added tax).[2]

Current law requires a state to establish that a business has a sufficient connection with the state before it may exercise its jurisdiction to impose a business activity tax. The state's tax must bear a relation to the level of activity of the business in the state.[3] The U.S. Supreme Court has held that a company meets the jurisdictional standard of sufficient contacts ("substantial nexus" in the words of the Court) if it is "doing business" in the state or otherwise engaged in "establishing and maintaining a market" in the state. It has also held that the tax is fairly related to the level of activity in the state if the multistate income of the company is apportioned among states in which the business is operating in a fashion that reasonably reflects the taxpayer's activity in the state.

Once jurisdiction to tax is established, state corporate income taxes generally operate as follows. The state tax base is federal taxable income of the taxpayer in all states, plus and minus certain modifications (e.g., to exclude certain income that states may not constitutionally tax). The income from activities in all states is then "apportioned" or divided among the states in which the company operates according to a formula that usually compares the corporation's payroll, property and sales (the factors) in the state with the company's payroll, property and sales "everywhere" or in all states.[4]

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[1] "*State Corporate Income Tax Rates 2000-2011, State Corporate Income Tax Rates, 2011*," The Tax Foundation, http://www.taxfoundation.org/taxdata/show/230.html, March 1, 2011.

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

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

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

Once the income attributable to an individual state is determined, the state's rates, credits and other adjustments are applied to determine the final tax owed.

What is being proposed?

BATSA would greatly curtail the instate business activity that a state can tax, primarily in two ways: (1) it significantly narrows state taxing jurisdiction by requiring that an entity must have one or more of certain specifically enumerated types of physical presence in a state before that state could impose a business activity tax on the entity;[5] and (2) it expands the reach and coverage of Public Law 86-272, a 1959 law intended to provide temporary restrictions on the ability of states to levy net income taxes on certain multistate businesses. This version also interferes with the recognized ability of states to calculate income derived from the state where the income is attributable to members of a unitary business group. The combination of the changes would establish a new framework in federal law that reverses current law. The new Federal framework would allow large, multi-state businesses to engage in tax structuring and planning that would enable them to avoid a significant part, if not all, of their state tax liabilities.

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

BATSA is often described as "codifying the current physical presence standard" for state tax jurisdiction. Despite the many statements to the contrary, the physical presence test has never been the standard for imposing business activity taxes on corporations. The U.S. Supreme Court has never held that a physical presence is required to meet "substantial nexus" requirement for the imposition of a state business activity tax. Instead, the Court has focused on requirements that the tax not discriminate, that income derived from the state be fairly apportioned, and that the method used reflect the benefits derived from the state.[6] In the only case, the 1992 *Quill* case, where the Supreme Court has used a physical presence test, the Court did so in order to be able to require the collection of state sales taxes from in-state customers by out-of-state sellers. In *Quill,* the Court specifically said it was not establishing such a requirement for other taxes. The BATSA legislation would, for the first time, prohibit a state from imposing a business activity tax on a company doing business in the state unless the company has specifically enumerated types of physical presence in the state.

Further, since *Quill*, the vast majority of state appellate courts that have addressed the question of whether the physical-presence requirement of *Quill* applies outside of the context of sales and use taxes have ruled that it does not. Those court decisions include: *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003),

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

[6] [2] See *Complete Auto Transit v. Brady* 430 U.S. 274 (1977).

cert. denied, 124 S.Ct. 961 (2003); *A&F Trademark, et al. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *review denied* (N.C., 2005), *cert. denied*, 126 S.Ct. 353 (2005); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 122 S.Ct. 1915 (2002); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), *cert. quashed* (N.M., 12/29/05); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07) ; *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), *appeal denied*, 731 N.E.2d 762 (Ill. 2000); *Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied*, *FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07); *KFC Corp. v. Iowa Dept of Revenue*, 792 N.W.2d 308 (Iowa 2010) Lamtec *Corporation v. Dept of Revenue of the State of Washington*, __ P.3d __, 2011 WL 206167 (Wash. 2011). These decisions indicate that the vast weight of the case law, from both the U.S. Supreme Court and state appellate courts, is that the physical-presence requirement of *Quill* does not apply outside of the context of sales and use taxes.[7]

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

BATSA would also negate U.S. Supreme Court decisions that found a company meets the "substantial nexus" requirement by virtue of activities performed on its behalf by others. Specifically, the Court's 1987 decision in *Tyler Pipe Industries, Inc. v. Washington State Dept of Revenue* would be reversed. In *Tyler Pipe,* the Supreme Court upheld the imposition of Washington's business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor, to establish and maintain a market in the state. BATSA provides that using the services of a representative to establish or maintain a market in a state would constitute a sufficient physical presence only if such representative were an "agent" of the entity and only "if such agent does not perform business services in the State for any other person...." BATSA effectively knocks the legs out from under *Tyler Pipe* by allowing a company to avoid taxation in a state simply by using someone else to do its work in the state, as long as that contractor performs services for at least one other entity. The contractor may, in fact, be a wholly owned subsidiary of the taxpayer, so long as it performs work for someone else.

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

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

How will BATSA create tax planning opportunities for large businesses?

There are several features of BATSA that will be used by multistate entities to structure and plan their operations and transactions to avoid state tax liability. These features include requiring certain types of physical presence in the state, prohibiting consideration of the activities of contractors in the state, and expanding the scope of activities excluded under P.L. 86-272. These provisions have particularly insidious effects when coupled with certain existing state laws such as single sales factor apportionment, which distributes income to the state based on the percentage of sales in that state compared to the company's sales in all states.[8]

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[8] Traditionally, states assigned equal weight to each of the three apportionment factors – property, payroll and sales. At the present time, 12 states employ (or allow on an optional basis) a single factor (sales) formula (i.e., sales are apportioned among the states based solely on the proportion of a company's sales in

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

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

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

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

No Physical Presence Business Operations. Larger businesses in certain industries are particularly well suited to conducting business in high volumes in a state without having physical presence as required under BATSA. As a result, they will be able to avoid state taxation if BATSA is enacted. Every service a bank offers – including savings accounts, loans, and investment services – can be offered while still having limited physical presence in a state. Under BATSA, large banks will be able to add to their economies of scale advantages, relative to local banks, by operating tax-free in many states even if they do hundreds of millions of dollars of business in those states. In fact, it is precisely this type of financial services operation (credit card issuance and servicing) that was carried on without a physical presence in the state and that was found to constitute a sufficient nexus in the *MBNA* case in West Virginia.[9] BATSA would overturn that case and similar statutes in several other states that apply an economic presence test to the instate activities of financial institutions.

Intangible Holding Company. A strategy used by a number major retailers is to create a holding company that is a wholly owned subsidiary to own the intangibles (patents, trademarks, service marks, etc.) of the retailer. Those intangibles are then licensed back to the retail entity, and each retail store is then required to pay a license fee (often just about equivalent to the profit earned by the store) to the intangible holding company. The holding company subsidiary is customarily located in a state that does not

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the state), 25 states employ a formula that has three factors but super-weight the sales factor, and 9 states use the traditional equally-weighted three factor formula.

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

tax income from the licensing of intangibles. The retail stores take a deduction as a current expense for the licensing fee paid to the holding company. This transaction has the effect of shifting income from the state where it is earned (i.e., where the stores are) to a state where the income is not taxable – even though the holding company and the retail stores are all part of one corporate group and the holding company commonly has little in the way of actual operations.

While this was done extensively in the past, it is currently considered risky tax planning. Many companies do not engage in such arrangements because a number of states have issued assessments against such holding companies that have been affirmed by the courts."[10] If BATSA becomes law, a state would be prohibited from taxing the holding company to which the income was shifted because the holding company would not have any of the specifically enumerated types of physical presence in the state. BATSA would prevent states where the retail stores are located from taxing the holding company even though the income came from the retail operations in that state. The physical presence rule in BATSA would likely result in many more companies using an intangible holding company structure to try to minimize their taxes because of the fiduciary duty they owe to their shareholders.

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

Using a Contractor. Another simple tax avoidance strategy under a BATSA regime involves the use of contractors in a state to perform activities necessary for a seller to maintain a market in the state. Assume, for example, an out-of-state retailer of computers or other electronic devices markets its products into a state via the Internet, sales people operating within the confines of P.L. 86-272, and other direct sales methods. Also assume that the sale of computers and electronic devices includes warranty contracts and that the out-of-state retailer sets up a separate affiliated entity (independent contractor) to provide the warranty service to its customers that it would otherwise have to provide. Assume further that the independent contractor affiliate provides similar services to other out-of-state retailers, all of which could be affiliates of one another.

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

Under BATSA, the out-of-state retailer would not be subject to a business activity tax in the state into which it sold the computers because the activities of the affiliate contractor, though essential to sale of the computers and performed on behalf of the seller, could not be attributed to the seller.

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

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

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

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

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

Response: The many, mostly arbitrary, physical presence requirements in the bill are far from "bright lines." BATSA carves out from the physical presence that might be attributed to a company in a state a number of instate activities. For example, one company could have 100 employees in a state for 14 days (1,400 person-days) and not have nexus, while another company could have 1 person in a state for 16 days (16 person-days) and have nexus. In addition, a company must have certain types of physical presence that are not protected by the expanded P.L. 86-272 and that do not fall within the *de minimis* exceptions of BATSA or the "limited or transient" exception in BATSA. The various limitations and carve-outs from physical presence will create confusion, uncertainty and litigation as companies attempt to move up to the line of BATSA, but not cross over it. Repeal of P.L. 86-272 and a fair, simple presence rule that includes all activities in the state would be a bright line. BATSA is not a bright line.

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

Response: The physical presence requirements of BATSA are not designed to assist small businesses. A small business with little presence outside its own state is unlikely to incur other state business tax liabilities since 1) the business likely has modest income, 2) the income, in any case, would have to be apportioned and 3) state tax rates are generally relatively low. BATSA, instead, intends to provide opportunities for large multi-state, multi-national corporate groups to structure and plan in order to avoid state taxes. The U.S. Constitution and due process considerations require more than a single sale before a state could exercise its tax jurisdiction. States are willing to work with the business community to structure *de minimis* standards that will provide clarity for small businesses, if that is what is really wanted. BATSA does not provide an appropriate framework for such a standard.

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

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

> This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible. A profitable corporation clearly enjoys both types of benefits. It is true that in-state corporations may receive greater benefits than their out-of-state counterparts, for example, because they have physical assets that need fire and police protection. But that is a question of the magnitude of benefits and the tax that is appropriate to finance them -- something that is properly addressed by the choice of apportionment formula and the tax rate, not the type of yes/no question that is relevant for issues of nexus. The answer must clearly be a resounding yes to the question of whether the state has given anything for which it can ask in return.[11]

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

Response: While "no taxation without representation" is a catchy slogan, the Supreme Court has long upheld the right of states to impose taxes on nonresidents (individuals and corporations) doing business in a state. Moreover, the companies

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

supporting BATSA have found plenty of avenues for making their desires known to state elected and appointed officials. Most importantly, the issue here is whether large businesses that can adopt complex corporate structures should be able to plan around any state tax liability. This would prevent the states from ever being able to achieve a fair system of taxation. States should be allowed to promote a system that taxes in-state and out-of-state businesses equally. If that is achieved, the in-state representatives will also effectively represent the interests of out-of-state businesses.[12]

Conclusion

Thank you Mr. Chairman for the opportunity to testify on the important subject of business activity tax nexus legislation. The current system of state taxation has developed over many years and we believe it is fundamentally sound. Legislation like H.R. 1439 turns the system upside down and would create massive revenue losses for the states. We urge you to reject the legislation.

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

Mr. COBLE. Thank you, Mr. Johnson.
Mr. COBLE. Mr. Henchman?

TESTIMONY OF JOSEPH HENCHMAN, TAX COUNSEL AND DIRECTOR OF STATE PROJECTS, THE TAX FOUNDATION (WASHINGTON, DC)

Mr. HENCHMAN. Thank you. Mr. Chairman, Ranking Member Cohen, Ranking Member Conyers and Members of the Subcommittee. I appreciate the opportunity to testify today on legislation pending before you on state tax actions that impact interstate commerce.

Let's say you have a retired congressman, he hires a research assistant, he decides to write his memoirs. So he rents a little office in a business park in Virginia. He hires a research assistant, a Virginian. He buys some computers and some printers from a Virginia company. And every day for a year he sits in that Virginia office writing his memoirs. And at the end of the year he sells the finished manuscript to a New York publisher.

Where did he earn that income? An economist will tell you that the congressman earned the income where he invested his capital and his labor, which is, in this case, Virginia. This is what is known as the "benefit principle," the idea that the taxes people pay are linked to the government services they receive. In other words, individuals and businesses should pay taxes where they work and live and jurisdictions should not tax those who don't work and live there.

While a physical presence rule for taxation is the norm in the international context and is the historical norm

for state taxation here in the United States, we at the Tax Foundation have been monitoring increasingly aggressive state efforts to reject this rule so as to shift tax burdens away from residents toward non-residents.

This is not entirely new. States have always had this incentive, to the detriment of the national economy. In fact in the time of the founding the use of tolls and taxes by states in this regard were a primary reason why we had the Constitutional Convention in the first place. And out of that convention it was decided that the free flow of goods and services is so important and it matters more than letting states tax certain types of transactions, that you, the Congress, have been empowered to preempt some state actions in that regard, for restraining the states from enacting laws that disrupt the national economy by discriminating against interstate commerce.

It is not a power to use lightly, but it rests with you because states have no incentive to get together and resolve this on it own. On the contrary, each state thinks it can get a bigger share of the national tax pie by adopting an aggressive nexus standard. But these—this leaves us all poorer because all businesses, large and small, must deal with complex tax regulations, uncertainty about what activities create tax obligations in different states, lack of uniformity between different states in tax rules and formulas and generally wasting significant amounts of time, wealth and brain power navigating tax compliance rather than doing more productive things.

These state actions deter new investment by domestic and foreign businesses who want no part of this quagmire and take their dollars and their jobs overseas. State spending overwhelming, if not exclusively, exists to benefit the people who live and work in the state. Education, health care, roads, police protection, the reasons states do these things is to benefit the residents. Residents should be willing to pay for these services that they demand. Instead, what we see are many states offering tax credits and waivers to select residents, businesses and individuals, while insisting on going off out-of-state corporations that engage in sales in the state. This is backwards and it is a violation of good tax policy. A physical presence standard for business activity taxes would correct this and be in line with the benefit principle which is a fundamental view of taxation.

As a country we have gone from the artisan to Amazon.com. But this sophistication of technological progress does not change the fact that state services are still based on physical geographic borders, so the tax system should be too.

And state fiscal pain does not justify overruling timeless constitutional principles, such as the idea that states shouldn't be allowed to burden interstate commerce and impose uncertainty in the national economy.

Sometimes small businesses call up my office, as I am sure they call up the other members of the panel, asking if I engage in activities in a state, what would create nexus. And the only reason answer I have for them is to send them this. This is BNA's annual survey of state tax actions. It is the questionnaire that Mr. Schroeder talked about where they ask I think it is over 100 questions of, would this activity create nexus, would this activity create nexus. This is—this should not be how we do our system. There has to be a better way.

Thank you.

[The prepared statement of Mr. Henchman follows:]

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The Role of Congress in State Tax Legislation: Ensuring that State Taxation Does Not Do Harm to the National Economy

Joseph Henchman
Tax Counsel & Director of State Projects
Tax Foundation

Hearing on the
Business Activity Tax Simplification Act of 2011

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

April 13, 2011

Mr. Chairman, Ranking Member Cohen, and Members of the Subcommittee:

I appreciate the opportunity to testify today on legislation pending before you on state tax actions that impact interstate commerce. Since the Tax Foundation's founding in 1937, we have monitored tax policy and developments at the federal and state levels: the wealth of data and research on our website is heavily relied upon by policymakers, media, and the general public. As a non-partisan organization, our analysis is guided by economic principles and the view that tax systems should strive to be simple, neutral, transparent, and stable.

What you have before you is not a new issue. Absent federal guidelines or court mandates, states have an incentive to shift tax burdens from physically present individuals and businesses to those who are beyond their borders. Indeed, it was states' unchecked behavior in putting tariffs and tolls on goods crossing state lines that led to the Constitutional Convention in the first place.[1] James Madison noted at the time that "the mild voice of reason, pleading the cause of an enlarged and permanent interest, is but too often drowned

[1] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring) ("[States' power over commerce,] 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."); 1 STORY CONST § 497 ("[T]here is wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other. A petty warfare of regulation is thus prevented, which would rouse resentments, and create dissensions, to the ruin of the harmony and amity of the states."); Statement of Gouverneur Morris, SUPPLEMENT TO MAX FARRAND'S THE RECORDS OF THE FEDERAL CONVENTION OF 1787 at 360 ("These local concerns ought not to impede the general interest. There is great weight in the argument, that the exporting States will tax the produce of their uncommercial neighbors.").

before public bodies as well as individuals, by the clamours of impatient avidity for immediate and immoderate gain."[2] Today, some states' actions threaten to do harm to the enlarged permanent interest of the national economy as they pursue immediate and immoderate gain.

Because of that experience, the Founders ensure that the Constitution that Mr. Madison helped write empowers you, the Congress, to restrain states from enacting laws that harm the national economy by discriminating against interstate commerce.[3] This is a power that you have exercised in past situations where preempting state taxation furthered the national economic interest:[4]

- Public L. 86-272, 73 Stat. 555 (codified at 15 U.S.C. § 381 *et seq.*) (preempting state and local income taxes on a business if the business's in-state activity is limited to soliciting

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[2] James Madison, THE FEDERALIST NO. 42 (1788).

[3] *See* U.S. CONST. art. I, § 8, cl. 3 (Interstate Commerce Clause); U.S. CONST. art. I, § 10, cl. 2 (Import-Export Clause); U.S. CONST. art. I, § 10, cl. 3 (Tonnage Clause); U.S. CONST. art. IV, § 2, cl. 1 (Privileges and Immunities Clause); U.S. CONST., amend. XIV, § 1 (Privileges or Immunities Clause). The power of the federal courts to act when Congress is silent is inferred as an implication of the Commerce Clause, a doctrine often referred to as the "dormant" or "negative" Commerce Clause. *See, e.g.*, *Willson v. The Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829).

The Commerce Clause prohibits states from imposing a tax on activity out-of-state while leaving identical activity in-state untaxed. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *Camps/Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine residents). *But see Dep't. of Revenue of Ky. v. Davis*, 553 U.S. 328 (2008) (upholding Kentucky's exclusion from tax of interest earned from its state bonds, but not other states bonds, on the grounds that Kentucky is acting as a market participant no different from any other bond issuer).

The Import-Export Clause prohibits states from penalizing activity that crosses state lines, particularly imports. *See, e.g.*, *Michelin Corp. v. Wages*, 423 U.S. 276, 295 (1976) (stating that the Import-Export Clause prohibits import taxes that "create special protective tariffs or particular preferences for certain domestic goods…."). The Tonnage Clause prohibits charges on shipping freight.

The Privileges and Immunities Clause of Article IV and the Privileges or Immunities Clause of the Fourteenth Amendment protects the right of citizens to cross state lines in pursuit of an honest living. *See, e.g.*, *United Bldg. & Constr. Trades v. Mayor*, 465 U.S. 208, 219 (1984) (identifying "pursuit of a common calling" as a privilege of citizenship protected by the Constitution); *Saenz v. Roe*, 526 U.S. 489 (1999) (invalidating a law that did not restrict state travel *per se* but discouraged the crossing of state lines with a punitive and discriminatory law); *id.* at 511 (Rehnquist, J., dissenting) ("The right to travel clearly embraces the right to go from one place to another, and prohibits States from impeding the free passage of citizens); Erwin Chemerinsky, CONSTITUTIONAL LAW 450 (2d ed. 2002) ("The vast majority of cases under the [Article IV] privileges and immunities clause involve states discriminating against out-of-staters with regard to their ability to earn a livelihood.").

[4] *See* Frank Shafroth, *The Road Since Philadelphia*, 30 STATE TAX NOTES 155 (Oct. 13, 2003).

sales of tangible personal property, with orders accepted outside the state and goods shipped into the state);

- 4 U.S.C. § 111 (preempting discriminatory state taxation of federal employees);
- 4 U.S.C. § 113 (preempting state taxation of nonresident members of Congress);
- 4 U.S.C. § 114 (preempting discriminatory state taxation of nonresident pensions);
- 7 U.S.C. § 2013 (preempting state taxation of food stamps);
- 12 U.S.C. § 531 (preempting state taxation of Federal Reserve banks, other than real estate taxes);
- 15 U.S.C. § 391 (preempting discriminatory state taxes on electricity generation or transmission);
- 31 U.S.C. § 3124 (preempting state taxation of federal debt obligations);
- 43 U.S.C. § 1333 (2)(A) (preempting state taxation of the outer continental shelf);
- 45 U.S.C. § 101 (preempting state income taxation of nonresident water carrier employees);
- 45 U.S.C. § 501 (preempting state income taxation of nonresident employees of interstate railroads and motor carriers and Amtrak ticket sales);
- 45 U.S.C. § 801 *et seq.* (preempting discriminatory state taxation of interstate railroads);
- 47 U.S.C. § 151 (preempting state taxation of Internet access, aside from grandfathered taxes);
- 47 U.S.C. § 152 (preempting local but not state taxation of satellite telecommunications services);
- 49 U.S.C. § 101 (preempting state taxation of interstate bus and motor carrier transportation tickets);
- 49 U.S.C. § 1513 *et seq.* (preempting state taxation of interstate air carriers and air transportation tickets);
- 49 U.S.C. § 40116(b) (preempting state taxation of air passengers);
- 49 U.S.C. § 40116(c) (preempting state taxation of flights unless they take off or land in the state);
- 49 U.S.C. § 40101 (preempting state income taxation of nonresident airline employees);
- 50 U.S.C. § 574 (preempting state taxation of nonresident members of the military stationed temporarily in the state).

As states are unlikely to slacken in their efforts to implement discriminatory tax policy, it is a power that I expect you will also use in the future. It's not one to use lightly, I must concede. Many components of state tax systems do not have the motivation or effect of protectionism or raiding revenue from out-of-staters, and should be left alone as part of our commitment to fifty simultaneous laboratories for policy experiments, to paraphrase Justice Brandeis.[5] If bad state policy can be corrected by the out-migration of people and dollars, or political pressure by voting resident taxpayers, it ought to be left to the states to handle.

That is not the case here. In recent years, we at the Tax Foundation have monitored the increasing use of tax policy by states to shift tax burdens away from (voting) residents toward nonresidents. Tourist taxes like excessive hotel or car rental taxes are an obvious,

[5] *See New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.").

though limited, example.[5] Much more expansive has been the decision by about half the states to adopt an "economic nexus" standard for business activity taxes, whereby businesses that have no property or employees within the state must nevertheless pay these taxes, such as corporate income taxes or gross receipts taxes. (See Figure 1.)

At the same time, states are giving in-state business exemptions, waivers, and credits from their corporate income tax. By our most recent count, 29 states offer resident businesses credits from state corporate income tax they would otherwise owe, if the resident business engages in research & development, new job creation, or new investment.[7] Many states do not consider in-state property or payroll when apportioning taxes owed by in-state corporations. While permissible under Supreme Court precedent, these actions have led to a long-term decline in the tax (see Figure 2).[8] It also results in a paradox: states excuse some resident businesses from paying part of their tax bills, while they demand that nonresident businesses pay taxes on profits that are properly taxed by other states. This is exactly the state behavior that the Founders warned about.

The reason the Founders favored the Congress to handle the matter was because states have no incentive to get together and resolve it on their own. On the contrary, each state tends to think it can get a bigger share of the national tax pie by adopting aggressive nexus standards. They can't all get a bigger share, of course, so while West Virginia may get a bit more revenue from a nonresident credit card company or Iowa may get a bit more revenue from a nonresident Kentucky fast food chain or New Jersey may get a bit more revenue by holding trucks at the state line, these actions leaves us all poorer.[9]

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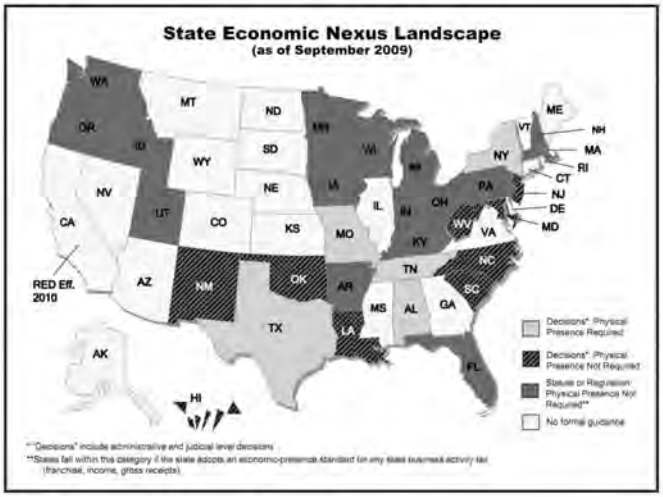
[5] *See, e.g.*, Joseph Henchman, "Cities Pursue Discriminatory Taxation of Online Travel Services: Real Motivation is to Shift Tax Burdens to Nonresidents; Result is Harm to Interstate Commerce," TAX FOUNDATION SPECIAL REPORT NO. 175 (Feb. 2010), http://www.taxfoundation.org/publications/show/25786.html; Andrew Chamberlain, "The Case Against Special Rental Car Excise Taxes," *Tax Policy Blog* (Apr. 18, 2006), http://www.taxfoundation.org/blog/show/1440.html.

[7] Kail Padgitt, "2011 State Business Tax Climate Index," TAX FOUNDATION BACKGROUND PAPER NO. 60, at 41, (Oct. 2010), http://www.taxfoundation.org/research/show/22658.html.

[8] *See, e.g.*, Organization for Economic Cooperation and Development, "Tax and Economic Growth," ECONOMICS DEPARTMENT WORKING PAPER NO. 620 (Jul. 11, 2008) ("[C]orporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes."); David Brunori, STATE TAX POLICY at 84 (2004) ("In many cases, the amount of time and resources devoted to the [state corporate income] tax outweighs its financial contribution to the states."); Richard Pomp, "The Future of the State Corporate Income Tax: Reflections (and Confession) of a Tax Lawyer," *in* THE FUTURE OF STATE TAXATION (David Brunori ed. 1998); J. Dwight Evans, "The Approaching State Corporate Income Tax Crisis," TAX FOUNDATION BACKGROUND PAPER NO. 14 (Sep. 1995), http://www.taxfoundation.org/research/show/870.html; Joel Slemrod & Marsha Blumenthal, "The Income Tax Compliance Cost of Big Business," TAX FOUNDATION SPECIAL ACADEMIC PAPER (Nov. 1993), http://www.taxfoundation.org/publications/show/639.html;

[9] *See, e.g.*, Melvin L. Burstein & Arthur J. Rolnick, "Congress Should End the Economic War Among the States," FEDERAL RESERVE BANK OF MINNEAPOLIS 1994 ANNUAL REPORT 9 (1):3-19 (urging a congressional end to states "using financial incentives to induce companies to locate, stay, or expand in the state.").

FIGURE 1: Status Quo on Nexus Standards for Business Activity Taxes



Source: Organization for International Investment.

All businesses must deal with the resulting complex tax statutes, uncertainty about what activities create tax obligations in different states, lack of uniformity between different states in tax rules and formulas, and generally wasting significant time, wealth, and brainpower navigating tax compliance rather than doing more productive things. These state actions also deter new investment by domestic and foreign businesses and entrepreneurs who want no part of this quagmire and take their dollars and their jobs overseas.

This "economic nexus" standard favored by about half the states means that tax obligations are owed wherever a company has sales or other economic activity. If this standard is widely adopted, we will not have corporate income taxes but corporate consumption taxes, whereby states mostly exempt resident companies from tax obligations while imposing them on out-of-state companies. This is backward and violates the "benefit principle"—the idea that the taxes you pay should be a rough approximation for the services provided by the government that you consume.

FIGURE 2: State Corporate Income Tax Collections as a Percentage of Total State Tax Revenue and as a Percentage of Total State Revenues

	% of Tax	% of Total		% of Tax	% of Total
1977	9.1%	4.5%	1994	6.9%	3.1%
1978	9.5%	4.8%	1995	7.3%	3.2%
1979	9.7%	4.9%	1996	7.0%	3.0%
1980	9.7%	4.8%	1997	6.9%	3.0%
1981	9.4%	4.6%	1998	6.6%	2.8%
1982	8.6%	4.2%	1999	6.2%	2.7%
1983	7.7%	3.7%	2000	6.0%	2.6%
1984	7.9%	3.9%	2001	5.7%	2.7%
1985	8.2%	4.0%	2002	4.7%	2.3%
1986	8.1%	3.8%	2003	5.2%	2.2%
1987	8.3%	4.0%	2004	5.1%	1.9%
1988	8.2%	4.0%	2005	5.9%	2.4%
1989	8.4%	4.1%	2006	6.7%	2.7%
1990	7.2%	3.4%	2007	7.0%	2.6%
1991	6.6%	3.1%	2008	6.5%	3.0%
1992	6.6%	2.9%	2009	6.1%	N/A
1993	6.8%	3.0%			

Source: US Census; Tax Foundation.

State spending overwhelmingly, if not completely, is meant to benefit the people who live and work in the jurisdiction. Education, health care, roads, police protection, broadband access, etc.: the primary beneficiaries are state residents. The "benefit principle" thus means that residents should be paying taxes where they work and live, and jurisdictions should not tax those who don't work and live there. A physical presence standard for business activity taxes would be in line with this fundamental view of taxation.

Five years ago, Mr. Michael Mundaca, now a Deputy Assistant Treasury Secretary, testified that international tax treaties from the 1920s to today are premised on physical presence, and states' move toward economic nexus could move us away from "uniform, predictable, and clear jurisdictional rules that minimize double taxation and that are easy to comply with and administer."[10]

That is still true today. The litigation about the physical presence standard in corporate, individual, and sales tax contexts has nearly exclusively been state efforts to overturn it or undermine it.[11] Economic nexus is a nebulous, amorphous standard that quickly leads to states asserting the power to tax everything, everywhere.[12] It is an alarming trend that even

[10] 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," (Jul. 25, 2006), http://www.hatsa.org/mundaca.pdf.

[11] States with aggressive sales tax statutes are Arkansas (just enacted this month), Colorado, Illinois, New York, North Carolina, and Rhode Island. All have either failed to collect any revenue and/or are subject to ongoing litigation.

[12] *See, e.g.*, Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (Nov. 5, 2007).

the best intentioned state legislator is being swept along in. It alarms me that a state could drive out business property and payroll and essentially become a fiscal basket case, yet still be able to collect revenue by grabbing it from businesses and individuals located in other states. States can thus pursue policy options that are unwise in the long-term but avoid the consequences of that choice.

These concerns are precisely why from the Founding until about the 1950s, the rule was that states could not tax interstate commerce at all, and that their power of taxation stopped at their border.[13] The Supreme Court formally abandoned this prohibition in 1977, out of recognition that resident businesses who are engaged in interstate commerce should pay for their fair share of state services they consume.[14] But given that inch, the states are in the process of taking a mile. For all the discussion about how nonresident companies benefit from the education of residents or investments in broadband, the real issue here is shifting tax burdens away from voting residents to someone else. As Professor Daniel Shaviro has put it, "Perceived tax exportation is a valuable political tool for state legislators, permitting them to claim that they provide government services for free."[15]

States revenues are in the process of recovering, although it varies by state and generally they will not rise to where they would have been under the overly optimistic revenue projections

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http://www.taxfoundation.org/commentary/show/22785.html ("Abandoning the physical presence rule in *International Shoe* led to confusion and uncertainty, resulting in an area of law in which no one is sure what the rules are. Abandoning the *Quill* physical presence rule would result in the same.... First, applying geography-based income taxes or geography-based sales taxes with a standard unconstrained by geography risks multiple taxation and burdensome compliance costs.... Second, simply imposing the existing taxation regime on e-commerce would burden e-commerce more than bricks-and-mortar businesses.... Third, there is a high likelihood that e-commerce would become subject to multiple taxation under an economic nexus standard.... Fourth, how far in space and time economic nexus can go remains undetermined.... Fifth, adopting an economic nexus standard would unsettle expectations and threaten retroactive application of taxes, endangering economic investments.... Overturning the present standard without being sure about what replaces it will repeat the mistake made by the progeny of *International Shoe*.").

[13] *See, e.g.*, *Freeman v. Hewit*, 329 U.S. 249, 252-53 (1946) ("A State is ... precluded from taking any action which may fairly be deemed to have the effect of impeding the free flow of trade between States"); *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888) ("No State has the right to lay a tax on interstate commerce in any form.").

[14] *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (holding that states may tax interstate commerce if the tax meets a four part test: (1) **nexus**, a sufficient connection between the state and the taxpayer; (2) **fair apportionment**, the state cannot tax beyond its fair share of the taxpayer's income; (3) **nondiscrimination**, the state must not burden out-of-state taxpayers while exempting in-state taxpayers; (4) **fairly related**, the tax must be fairly related to services provided to the taxpayer. The case came about after a series of cases in the 1950s and 1960s where the Court treated essentially identical taxes differently based on "magic words" in the statute. For example, an annual license tax imposed on the in-state gross receipts of an out-of-state company was invalidated as discriminating against interstate commerce, but an otherwise identical franchise tax on in-state going concern value, measured by gross receipts, was upheld as valid. *Compare Ry. Express Agency v. Virginia*, 347 U.S. 359 (1954) ("*Railway Express I*") *and Ry. Express Agency v. Virginia*, 358 U.S. 434 (1959) ("*Railway Express II*").

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

at the height of the boom.[16] But state fiscal pain does not justify beggar-thy-neighbor policies that impose significant compliance and deadweight losses on the national economy. State power to tax should not extend to everything everywhere. Simplification should be something everyone embraces. As Chief Justice Marshall said, "The power to tax is the power to destroy."[17] And state tax overreaching with aggressive nexus standards can destroy.

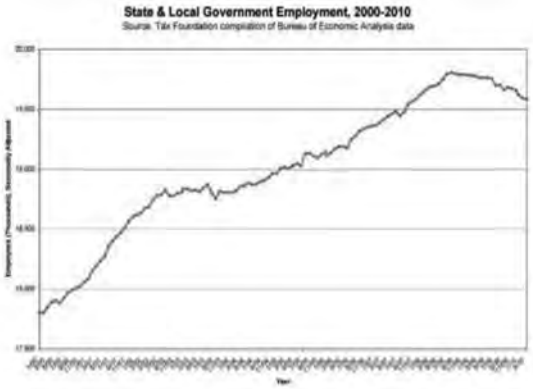
As a country we have gone from the artisan to Amazon.com. But the sophistication of technology does not overrule timeless constitutional principles meant to restrain states from burdening interstate commerce and imposing uncertainty on the national economy.[18]

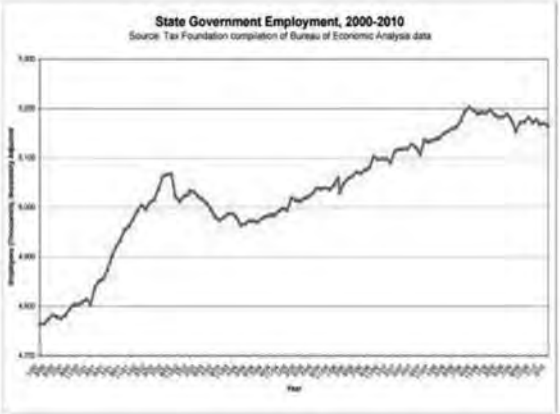
Thank you.

[16] *See, e.g.*, Joseph Henchman, "State Budget Shortfalls Present a Tax Reform Opportunity," TAX FOUNDATION SPECIAL REPORT NO. 164 at 9 (Feb. 2009), http://www.taxfoundation.org/research/show/24321.html ("Those states hardest hit by the recession are those that relied the most heavily on capital gains, high-income earners, and corporate profits… Revenue from [these tax sources] does spike during times of economic boom, but it plummets during a bust. States without spending controls get into trouble by assuming for spending purposes that the years of revenue windfall will continue.").

[17] *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819).

[18] *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 902 (1992) ("Today's more integrated national economy presents far greater opportunities than existed in 1787 for states in effect to reach across their borders and tax nonconsenting nonbeneficiaries.").





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Mr. COBLE. Thank you, gentlemen for your testimony. We appreciate you being with us. We will now examine the witnesses.

Mr. Schroeder, how has the uncertainty and lack of predictability concerning different states' nexus requirements affected your small business?

Mr. SCHROEDER. Yeah. In my case it is simply a matter of management time and attention and as well as the cost and expense of trying to comply. We spend, as I mentioned, you know, over—almost a $100,000 a year in our already highly regulated business, and that is dollars and time and attention that is not spent on growing our business, launching new franchisees or developing new

business concepts. And it is simply a matter of I don't know what the rules are, I probably could benefit from that and it would take even more of my time to figure out which of the 34 states I operate in I should be filing state tax returns in.

Mr. COBLE. Thank you, sir.

Mr. Johnson, is it your position that states should be entitled to discriminate against a company based on whether it sells tangible goods or intangible goods and services?

Mr. JOHNSON. That is certainly not my position, Mr. Chair. In fact that is imposed on us by Public Law 86–272. And again——

Mr. COBLE. Now we—Mr. Johnson, would you oppose modernizing Public Law 86–272?

Mr. JOHNSON. Well, if a physical presence is what is sought, and I don't believe a physical presence test is appropriate, I don't believe we should go back to the way the last—business was conducted in the last century to impose taxes in the new century, but if you want a physical presence standard, you have to repeal 86–272, because 86–272 allows a physical presence and protects it from taxation, as long as the activities are limited to the solicitation of sales of tangible personal property.

So if a physical presence is sought, then repeal of 86–272 is required.

Mr. COBLE. Well I thank you, sir.

Now Mr. Henchman, speaking of physical presence, why do you believe that a physical presence standard for net income and other business activity taxes is consistent with the holding of Quill? If you do believe that.

Mr. HENCHMAN. I do believe that. The Quill decision, of course, by its own terms was restricted to sales taxes. And as Congressman Goodlatte's answer to Representative Quigley earlier indicated, this bill does not address sales taxes one way or the other, because I know different people have different views on that. It just deals with business activity taxes and the view that the physical presence—and for me it just comes down to the basic economics as I said in my testimony. The residents of a state benefit from the services provided by a state. And to the extent a state is providing benefits to nonresidents, maybe they ought to be voted out of office because the reason you get elected to office is to provide benefits to your residents that vote for you. And those are the people that should be paying taxes to support those services.

Mr. COBLE. I thank you, gentlemen.

The Chair recognizes the distinguished gentleman from Michigan. I yield back my time, by the way. Mr. Conyers is recognized for 5 minutes.

Mr. CONYERS. Thank you, Chairman Coble.

Mr. Johnson, is—are there any tax avoidance opportunities that we ought to frankly talk about here? It has been said that we might create tax planning opportunities to eliminate tax—state taxation revenues that are earned in a state. Can you amplify?

Mr. JOHNSON. Yes. Thank you, Congressman.

As I indicated, I practiced for 17 years representing businesses, many of them large businesses. And if this bill were passed in its current form it would be malpractice for me not to recommend a number of structuring techniques.

One of the simplest would be to take the issue of a toy store, Toys R Us, for example. And I use that example because it is the subject of some well known litigation. For any retailer——

Mr. CONYERS. Does some of that litigation——

Mr. JOHNSON [continuing]. Doing business in the state——

Mr. CONYERS. Does some of that litigation involve tax avoidance?

Mr. JOHNSON. Yes, it does. By creating an intangible holding company and charging a royalty, then a company can essentially eliminate its profits in a state or reduce them dramatically by paying a royalty to a holding company in Delaware or offshore and deducting the royalty which can completely eliminate its profit margin in the state. That would be a simple example.

Another example would be creating a—if I had a business that was selling software for payroll and software for accounts receivable, for example, and part of my business model was to be able to repair and install that software and say I got a third of my revenue from each of those things, I would simply create three different subsidiaries. The repair subsidiary would then become subject to Utah tax. I could structure the sales of the payroll subsidiary and the sales of the accounting subsidiary to be exempt from Utah tax. I could cut my Utah tax in—by two-thirds by the simple expedient of creating three separate subsidiaries.

Mr. CONYERS. Any Federal tax opportunities involved?

Mr. JOHNSON. Well, the Federal tax—this same kind of planning goes on at the Federal level.

Mr. CONYERS. It could be local or Federal taxes?

Mr. JOHNSON. Yes.

Mr. CONYERS. Okay.

Mr. JOHNSON. But this would provide a blueprint for legitimized—and tax planning is something we recognize is legitimate.

Mr. CONYERS. Well——

Mr. JOHNSON. A company has no moral obligation——

Mr. CONYERS [continuing]. Look, we just left the Wall Street debacle and there were some tax organizations that didn't do very well in those investigations.

Mr. JOHNSON. There is definitely a line that can be crossed. But this would authorize many of these techniques.

Mr. CONYERS. Well, you have sufficiently disturbed me with this information.

Thanks, Chairman.

Mr. COBLE. Thank you, Mr. Conyers.

I say to my Members, we are going to have a vote here soon. I think we can probably wrap this up.

I am now recognizing the distinguished gentleman from South Carolina.

Mr. GOWDY. Thank you, Mr. Chairman.

Mr. COBLE. I almost demoted you, Trey.

Mr. GOWDY. And California would never allow me to set foot in that state, Mr. Chairman, I don't think. I am sure I have warrants pending.

Mr. Henchman, the substantial nexus test, how—what are the elements of it, how is it applied today?

Mr. HENCHMAN. It is laid out in the—for—in this case it is laid out in the bill and essentially—it is essentially property and pay-

roll. And I do want to indicate that it is a substantial nexus test, not the sufficient context test used for personal jurisdiction, as Mr. Johnson indicated, that is a completely less—that is a lower standard that the Supreme Court has never held to be the case for tax purposes.

Mr. GOWDY. Are there limits to Congress' ability to regulate state tax structures?

Mr. HENCHMAN. This bill does not address that, so——

Mr. GOWDY. In your judgment, are there limits to what we can do with respect to state tax structures?

Mr. HENCHMAN. Well, the Constitution permits the Congress to regulate commerce as it sees fit.

Mr. GOWDY. Yeah, but that is a very amorphous, increasing elastic——

Mr. HENCHMAN. It is.

Mr. GOWDY [continuing]. Term.

Mr. HENCHMAN. It is. And in terms of preempting certain state activities, I think even a limited reading of the Commerce Clause finds that power existing with Congress. There are——

Mr. GOWDY. Mr. Johnson, you——

Mr. HENCHMAN [continuing]. Probably a lot of things you could——

Mr. GOWDY. Let me ask, Mr. Johnson. What are the limits as you see them? Because I didn't write the note down and at my age my memory slips, but you questioned, perhaps or maybe I misunderstood you, whether Congress would have the authority to do certain things with respect to state tax structures or perhaps—I don't want to put words in your mouth. What do you think about it?

Mr. JOHNSON. I think there are certainly—I think there are certainly steps that Congress could take that would be so extreme that they could be struck down as unconstitutional. P.L. 86272 has not been challenged, to my knowledge, so I don't—our position is not that this bill would be unconstitutional, our position is that just because the Federal Government may have the authority to impose this bill doesn't mean it is a good idea.

Mr. GOWDY. What remedy would you propose?

Mr. JOHNSON. I would echo the comments of Congressman Cohen. I would like to see the businesses get together with the states and have a brighter line standard. I think it should include sales, but I think there should be some clear de minimis standards.

I tried to propose something in Utah and I didn't get much support from anyone, either on the business side or from my legislators on it. But I—as someone who, again, has represented taxpayers, I do think more certainty in the area would be appropriate. And I would encourage states to adopt brighter line standards. But I think the states should be able to do so based on their own elected legislators. And I would encourage the business community to work with the states in accomplishing that.

Mr. GOWDY. Mr. Henchman, what would be your perspective on that remedy?

Mr. HENCHMAN. Well, I would say there is no incentive the states will ever do that. And on the contrary, the incentive is to move away from apportionment—away from uniformity. And we have seen that in apportionment, where back in the '50's Congress

and through the Willis Commission threatened, look, this is a mess in apportionment, and so you guys just need to adopt a standard otherwise we are going to do it for you. And it took until a bill nearly being passed by Congress for the states to get together and adopt a uniform standard.

And since Congress has moved to other matters, the states have now wandered off and now we have all these different apportionment standards. That is the way states go on these things. It is going to take Congress or the courts to impose uniformity, the states are not going to do it on its own.

Mr. GOWDY. Mr. Schroeder, I am from South Carolina and if I can help you navigate that form, I will be happy to try and help, but thank you for doing business in South Carolina.

And with that I would yield back the remainder of my time, Mr. Chair.

Mr. COBLE. I thank the gentleman from South Carolina.

The gentleman from Tennessee, Mr. Cohen is recognized.

Mr. COHEN. Thank you, sir.

Are all of you all familiar with the Section 4 of this H.R. 1439? Mr. Johnson, you are?

Mr. JOHNSON. Pardon me?

Mr. COHEN. Section 4, the new section in H.R. 1439?

Mr. HENCHMAN. The Joyce Finnigan Provision I think?

Mr. JOHNSON. Yes.

Mr. COHEN. You're familiar with it then. What do you think about it, sir? It was not in the prior Business Activities Simplification Act.

Mr. JOHNSON. Well——

Mr. COHEN. How does that impact state governments?

Mr. JOHNSON. To—a simple example would be the—under the prior versions of the bill the technique I talked about where you would set up an intangible holding company for trademarks, that would not have worked in Utah, because we are a combined state. We would have taken the position that both the trademark holding company and the retailer are a single business entity as long as one of them has nexus in the state, the other one wouldn't. So that technique would not have worked under prior bills.

Under this bill it will work because we are required to consider each individual member of the combined group, individually, for purposes of determining whether or not it has nexus under this provision. So this is a dramatic expansion of the preemption.

Mr. COHEN. So you are against it?

Mr. JOHNSON. I am very much against it.

Mr. COHEN. Yeah, I would think so.

Mr. Henchman, where are you on this?

Mr. HENCHMAN. The—what is at issue here is basically two different interpretations of how you calculate nexus for different states, it is known as the Joyce standard and the Finnigan standard. The Joyce standard brings in—does not bring in entities for which the state doesn't have nexus, the Finnigan standard does.

We view the Finnigan standard as the more aggressive one and the Joyce one as not. And this statute would enshrine the Joyce standard which limits state taxation to those entities that are actually have nexus with the state.

Mr. COHEN. Mr. Schroeder, are you familiar with this?

Mr. SCHROEDER. I am sorry, I didn't hear.

Mr. COHEN. Are you familiar with this section of the law?

Mr. SCHROEDER. I am not in detail, but judging from what I am hearing is, you know, what we are looking for as a small business is simply a bright line test that helps us establish where do we have nexus and understanding why, because we want to make sure we spend as much of our resources as possible helping our franchisees grow and to grow their business and we need some clarity and reduction of uncertainty to be able to do that.

Mr. COHEN. Now you are a franchisor.

Mr. SCHROEDER. Right.

Mr. COHEN. And you are here because you are a member of the franchise association, but you don't necessarily representative the franchise association. Is that correct?

Mr. SCHROEDER. Correct.

Mr. COHEN. All right. So you do not know the—but the franchise association is 100 percent consistent with your position?

Mr. SCHROEDER. Yes.

Mr. COHEN. Okay. I got you.

I yield back the remainder of my time. Thank you.

Mr. COBLE. Thank you.

Trent, if you can keep it fairly brief I think we can get out of here, if you will do that.

Mr. FRANKS. I will move it, Mr. Chairman.

Mr. COBLE. The distinguished gentleman from Arizona, Mr. Franks.

Mr. FRANKS. All right. Mr. Johnson, what is your response to the stories from companies such as Outdoor Brands that small businesses facing this kind of Hobson's Choice of either hiring expensive accountants to decipher the various state laws or the state nexus rules or roll the dice and just make the best conclusion they can and sometimes end up having a major tax liability. I mean isn't that sort of a textbook example of kind of taxation without—that is unduly burdens to interstate commerce?

Mr. JOHNSON. Well, as I stated, Congressman Franks, I have some sympathy for that position and I think the states have been somewhat derelict in not providing clearer standards. And I think a clear standard, for example, might include a de minimis amount of sales. If you don't have more than $250,000 worth of sales into the state, for example, that might be a good bright line.

But with regard to franchises, franchise—the whole idea of a franchise is that when I am driving through Colorado or Wyoming or South Carolina and I see a franchise that I am familiar with from Utah, I am more likely to go to that business. I am more likely to participate there, patronize that business because it has built up good will in the state. So to say that a franchisor doesn't benefit from the market created in Utah, I think frankly is not correct.

Mr. FRANKS. Well, Mr. Henchman let me just ask you one question here sort of a combination question.

I know that some states are already using the physical presence standard for net income and business activity taxes, even though I don't think the Supreme Court has ever required it. So touch on that.

And then also the recent Iowa Supreme Court decision held that Kentucky—a Kentucky franchiser had a physical presence in Iowa because the franchisee was using the franchisor's intellectual property to, you know, pursuant to a franchisor contract arrangement. And that is—boy, that is something that is very hard for a business to—you know, I came from a small business background——

Mr. HENCHMAN. Right.

Mr. FRANKS [continuing]. And sometimes businesses don't know whether to jump or go blind. And tell me, what do you think about that and what is the answer to it.

Mr. HENCHMAN. Sure. I mean Mr. Johnson and I think some of the members have talked about tax planning. There is also issues of this is just how they have designed the business. I mean if somebody is structuring their business with the intent of avoiding taxes they owe, then Mr. Johnson and his fellow tax commissioners have the legal power to go after them. I mean you can do (inaudible) reporting, you can do unitary, you do a whole bunch of other—and you can prosecute them.

If it is just made up to avoid taxes you can go after them and nothing in this bill stops that. But with people who legitimately structured their business in that way, they face a lot of problems the way the system is set up now.

Mr. FRANKS. Yeah. Well Mr. Chairman, I will just make a comment and I am through. It seems to me, you know, the IRS and tax agencies are always saying that businesses and individuals have every right to pay as little taxes as they can, within the clear confines of the law. But when the confines of the law are just completely murky it is not fair to businesses or individuals and it is the responsible of Government to make those lines clear. And of course, in my judgment, also to somehow find ourselves somewhere in the vicinity of the Constitution at the same time.

So with that I yield back.

Mr. COBLE. I thank the gentleman.

Good news for the witnesses, we won't keep you here all the rest of the afternoon waiting for us to return. I thank you all for your testimony. Your written statements will be made part of the record.

We appreciate those in the audience for your presence today as well.

Without objection all Members will have 5 legislative days to submit to the Chair additional written questions for the witnesses which we will forward and ask the witnesses to respond as promptly as they can do so with their answers that may also be made a part of the record. Without objection all Members will have 5 legislative days to submit any additional materials for inclusion in the record.

And this hearing stands adjourned.

[Whereupon, at 2:35 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

April 13, 2011

The American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record for the hearing held on H.R. 1439, the Business Activity Tax Simplification Act of 2009 (BATSA). ABA would like to express our support for BATSA and encourage the Judiciary Committee to mark up this important legislation.

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 certain clearly defined situations, such as 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 Bob Goodlatte (R-VA) and Bobby Scott (D-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 has contacts with 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 therefore, have contacts with consumers residing in different states. 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 find themselves subject to different states' 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. The result would be fewer products offered to consumers at higher prices. Worse yet, without business certainty, some financial service providers may 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 in order for a state to impose tax on an out-of-state business. 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 Bob Goodlatte (R-VA) and Bobby Scott (D-VA), who have introduced H.R. 1439 to address 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 – this will greatly help streamline the out-of-state business activity tax within states and limit businesses' exposure to burdensome business activity taxes.

April 13, 2011

The Honorable Howard Coble
House Judiciary Committee
Subcommittee on Courts, Commercial and Administrative Law
United States House of Representatives
Washington, DC 20515

The Honorable Steve Cohen
House Judiciary Committee
Subcommittee on Courts, Commercial and Administrative Law
United States House of Representatives
Washington, DC 20515

Dear Chairman Coble, Ranking Member Cohen and Members of the Subcommittee:

The American Financial Services Association (AFSA) urges you to support H.R. 1439, the *Business Activity Tax Simplification Act* (BATSA), which would prohibit state taxation of an out-of-state entity unless such entity has a physical presence in the taxing state.

Based in Washington, DC, AFSA is the national trade association for the consumer credit industry, protecting access to credit and consumer choice. Its 350 members include consumer and commercial finance companies, auto finance/leasing companies, mortgage lenders, credit card issuers, industrial banks and industry suppliers.

Federal legislation in this area is clearly needed. The Supreme Court has declined to rule on the "substantial nexus" standard as applied to business activity taxes. Thus, many state governments have filled the void left by the Court by creating a complex set of different tax rules.

BATSA will provide clear guidelines which will ensure fairness and create a secure business environment that will encourage businesses to invest and to expand interstate commerce. The legislation will also minimize expensive litigation for taxpayers and state governments.

Thank you for your attention in this matter.

Respectfully,

Bill Himpler
Executive Vice President

Testimony

of the

American Homeowners Grassroots Alliance

Submitted to the

House Judiciary Commercial and Administrative Law Subcommittee

Hearing on

H.R. 1439: The Business Activity Tax Simplification Act of 2011

April 13, 2011

The American Homeowners Grassroots Alliance (AHGA) commends the House Judiciary Commercial and Administrative Law Subcommittee for holding this hearing on business activity taxes. AHGA is a nonpartisan consumer advocacy organization which focuses on policy issues that have a significant economic impact on the nation's 75 million homeowners.

Nexus is the key issue related to the application of business activity taxes as well as the obligation of Internet-based businesses to provide state and local sales tax collection services for the approximately 7,000 state and local taxing authorities outside of those businesses' home jurisdictions. Historically nexus has been defined as a physical presence, i.e. a physical facility such as a headquarters, warehouse, sales office etc.

Business activity taxes impact homeowners and other consumers. Business activity taxes are inevitably passed on to consumers and are directly burdensome to the growing numbers of home-based businesses, which now number 18 million, according to U.S. Census figures. For these reasons AHGA supports H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA"), which would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and comparable taxes on a business. It would set a universal fair standard for defining nexus and it addresses the question of whether digital commerce, Internet use, the movement of intangible goods and software, and similar activities would create physical presence in a state.

A growing share of home based and other micro businesses are Internet-centric. Although they sell their products and services across the country very few have a physical presence anywhere except their home jurisdiction. They face a nexus related challenge – the trend of state and local governments in other jurisdictions to impose business activity taxes on them based on new "economic nexus" concepts, even though those companies have no physical presence in the taxing jurisdiction. As a result they are effectively being forced to help underwrite a state infrastructure that they place no burden on and do not receive any benefit from.

Neither businesses nor consumers favor the new "economic nexus" approaches to expanding business activity tax liability. In fact, according to a 2008 Parade Magazine survey of 3,125 readers, 85% of consumers oppose taxes on Internet sales. Consumers do not want any state and local sales taxes imposed on their Internet purchases, and they do not want those purchases to be taxed indirectly through the imposition of business activity taxes on their Internet suppliers. It is logical that they would also not want to pay more for products from out of state non-Internet suppliers of goods and services through the imposition of unjustified business access charges. State and local government officials who wish to reflect the will of their constituents should be supporting ways to reduce business taxes on Internet companies.

Restricting the expansion of business activity tax liability is also sound tax policy. Imposing unjustified new business activity taxes raises the costs of those products to consumers and reduces the international competitiveness of U.S. companies. These taxes also violate the U.S. Constitution by unduly burdening the free flow of interstate commerce.

Encouraging Internet commerce is also sound environmental and economic policy. A drive to the mall generates greenhouse gasses, contributes to traffic congestion, and creates wear and tear on the transportation infrastructure. A consumer who uses Internet commerce to eliminate as little as 1,000 miles annually in driving to stores reduces CO2 emissions by about 1,000 lbs a year and saves about $200 in gas expenses. A click of the mouse therefore reduces the demand for gas, helping to keep gas prices down while also saving state and local governments on transportation infrastructure maintenance costs. The mail carriers and FedEx, UPS or vendors' trucks delivering your orders will be coming down your street anyway, so Internet commerce does not create any additional costs or adverse consequences. Americans work more hours than any other society. Internet commerce also saves consumers a lot of time, a precious commodity for all of us in our society where long working hours leaves too little time for personal relationships and other interests.

For all these reasons AHGA urges all the members of House Judiciary Commercial and Administrative Law Subcommittee to support the Business Activity Tax Simplification Act of 2011, as well as other efforts to encourage the use of Internet commerce.

AMERICAN LEGISLATIVE EXCHANGE COUNCIL ALEC

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on Courts, Commercial and Administrative Law
517 Cannon House Office Building
Washington, DC 20515

April 13, 2011

Dear Chairman Coble, Ranking Member Cohen, and Members of this Subcommittee,

As you may know, the American Legislative Exchange Council (ALEC) is the nation's largest, nonpartisan, individual membership association of state legislators. ALEC's Tax and Fiscal Policy Task Force works with our members to develop responsible tax policy that promotes simplicity, predictability, transparency, and economic growth. Based on these key principles, ALEC supports the physical presence standard for business activity taxes within the Business Activity Tax Simplification Act of 2011(H.R. 1439).

Direct state and local taxes on business, also known as "business activity taxes," such as income, franchise, net worth, business license, business and occupation, capital stock, and the like, impose great burdens on businesses engaged in interstate commerce. To ensure a healthy national economy, we urge policymakers to simplify business activity taxes to ensure that only businesses with a physical presence in the state will be required to pay these taxes.

The physical presence standard for business activity taxes promotes predictability and ensures that businesses who receive benefits and protections provided by state and local governments pay their fair share for the services they utilize. We believe H.R 1439 provides a simple and logical framework for business activity taxes that will protect interstate commerce. A business activity tax filing requirement based on any rule other than the physical presence standard would result in costly filing requirements and increased transaction costs for businesses.

Furthermore, ALEC's Tax and Fiscal Policy Task Force recently passed a "Resolution on State and Local Business Activity Taxes" in support of the physical presence standard. We believe that the Business Activity Tax Simplification Act of 2011 is pro-growth legislation which promotes responsible and effective tax policy.

Sincerely,

Senator Jim Buck, Indiana
Public Sector Chairman
Tax and Fiscal Policy Task Force
American Legislative Exchange Council

Jonathan Williams
Director, Tax and Fiscal Policy Task Force
American Legislative Exchange Council

Prepared Statement of

American Trucking Associations

Before the

Subcommittee on Courts, Commercial and Administrative Law

Committee on the Judiciary

United States House of Representatives

April 13, 2011

Hearing on H.R. 1439

The Business Activity Tax Simplification Act of 2011

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

Interstate commerce depends very heavily on efficient freight transportation. Most of that freight is carried by truck – some 68% by tonnage and some 82% 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. 1439, the Business Activities Tax Simplification Act of 2011, represents the kind of effort that is necessary. We urge Congress to enact such business tax relief promptly.

Background

Until 1980, interstate motor carriers were subject to strict federal regulation in an economic sense. Prior to deregulation, individual trucking companies did not typically travel in more than a few states and therefore were not exposed to taxation in many states. The great expansion in the number of trucking companies and in the scope of their operations in a largely deregulated economy has changed that. And with deregulation, states began to tap what they saw as a new source of revenue. The fact that trucking companies might be involved in critical areas of interstate commerce seems to have made them more rather than less attractive objects for taxation for states and localities, since, in any given place, most of the trucks passing through do not represent local residents but businesses from outside the state.

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[1] Some 90% of motor carriers operate fewer than six trucks; some 3% operate more than twenty. American Trucking Assns., *2010-2011 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.

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, 2009, and 2010 were 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. Only in 2011 do we expect to see anything like 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., *2010-2011 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

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.

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" rules, 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,

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).

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 Courts, Commercial and Administrative Law

on H.R. 1439: The Business Activity Tax Simplification Act of 2011

April 13, 2011

Statement of the National Association of Manufactures

Before the

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

Hearing on
H.R. 1439: The Business Activity Tax Simplification Act of 2011

April 13, 2011

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 April 13, 2011, House Judiciary Subcommittee on Commercial and Administrative Law hearing on H.R. 1439, The Business Activity Tax Simplification Act of 2011.

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 of Bobrick Washroom Equipment, Inc., for 18 years. Bobrick, a member of the NAM, is the leading company in the world for 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. 1439, the Business Activity Tax Simplification Act (BATSA), introduced in 2011 by House Judiciary Committee members Bob Goodlatte (R-VA) and Bobby Scott (D-VA). By establishing a bright-line physical presence test for when a state can tax out-of-state companies, BATSA will prevent the arbitrary state taxation of interstate commerce without jeopardizing the ability of states to legitimately tax companies with operations in the state.

Some states currently assess business activity taxes (BAT), e.g. income, franchise, or gross receipts taxes, on out-of-state manufacturers and other businesses that do not have any employees or property in the state. This arbitrary taxation of out-of-state businesses interferes with interstate commerce. Lawmakers last addressed this issue in 1959, when they clarified that a state cannot impose income taxes on an out-of-state company if the company's only contact with the state is to solicit orders for sales of tangible goods. BATSA would update the current "safe harbor" for soliciting sales of tangible goods to include 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, also 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 product orders 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.

Moreover, this trend is increasing and states are becoming more aggressive in attempting to increase revenues from levying business activity taxes. In the past 18 months, we have had requests from 15 states asking us to complete a questionnaire, consisting of 15 to 40 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. Based on the requests received this year, we expect to receive more requests from states in 2011 than we have received during the last decade.

There is no single litmus test to determine nexus for 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 the past, Bobrick generally has been able to answer most questions about presence in the negative and there have been no further inquiries from the state. However, this approach appears to be changing. The company recently received a questionnaire from Michigan that would impose nexus if we "actively solicit" through the use of the internet.

In addition, some states phrase a question in such a way that a "no" answer is not appropriate. For example, the compound question by the state of Texas includes 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 and a significant amount of internal staff time. The company filed a "Claim for Refund of Sales and Use Tax" with the Texas Comptroller of Public Accounts. Once Texas rejected this claim in 2010, we halted pursuing further legal action due to the high cost associated with such litigation and settled with the state.

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 challenge successfully the imposition of business activity taxes, most companies can not justify the cost of a challenge. As we found in Texas, a company first must exhaust all the state remedies, both administrative and through the state courts before the company can proceed to federal court in the hopes that the U.S. Supreme Court eventually will take the case. Based on our estimates, this process could take multiple years and cost millions of dollars in legal fees. This situation is blatantly unfair and particularly burdensome for small and medium size companies that do not have in-house legal departments to fight this arbitrary state taxation.

With more and more states taking an aggressive stance in imposing arbitrary business activity taxes on out-of-state companies, this additional taxation increases effective tax rates for U.S.-based companies, making it harder for these companies to compete globally. Also, these businesses will be subject to additional costs including collecting resale certificates and undergoing audits from various states.

Summary

The NAM strongly supports enactment of BATSA, which would establish a bright-line, physical presence test to determine when a state can levy income, franchise, gross receipts and other business activity taxes on out-of-state companies engaged in interstate commerce. By updating current law, BATSA would prevent a state from imposing business activity taxes on an out-of-state company if the company's only contact with the state is to solicit sales of tangible and intangible goods and services. Companies without a physical presence in a state would not be subject to business activity taxes simply because they have worldwide customers.

The legislation also would clarify that a state could 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.

Based on the increasing and arbitrary imposition of state taxes on out-of-state businesses, we strongly urge the full committee to take up and report favorably H.R. 1439, as soon as possible. Thank you in advance for supporting this important legislation. Bobrick, as well as companies of all sizes – particularly small manufacturers – would benefit from the clarity and certainty provided by this important legislation.

Supplemental Sheet

House Judiciary Subcommittee on Courts, Commercial and Administrative Law
Hearing on H.R. 1439: The Business Activity Tax Simplification Act of 2011
April 13, 2011

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COALITION FOR RATIONAL AND FAIR TAXATION

April 13, 2011

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

Re: Hearing on H.R. 1439, the Business Activity Tax Simplification Act

Dear Chairman Coble and Ranking Member Cohen:

Thank you for the opportunity to submit this statement for the record for the April 13, 2011 hearing on the Business Activity Tax Simplification Act 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"), recently introduced as the Business Activity Tax Simplification Act of 2011, H.R. 1439, 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 utilizing "hardball"

[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).

tactics[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[7] and other sales and use taxes.

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 first came to the fore 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-settled rule" and fueled significant concern within the business community that the states could

[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).

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*, 968 So. 2d 18 (AL Ct. Civ. App. 2006)); *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]

Consistent with its codification of a physical presence standard, BATSA provides that, in the context of a consolidated/combined return, the group return can only include in its apportionment factor numerators the in-state apportionment factors from corporations that have a physical presence in the state and that are not otherwise shielded from taxation by federal or state law.

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 imposes a tax based on gross receipts, and the Texas Margin Tax, 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

[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.

Public Law 86-272. In other words, New Jersey has effectively circumvented the Congressional policy decision underlying the enactment of Public Law 86-272 by imposing a non-income tax only on those businesses that would otherwise be protected. While other states have not yet enacted such a targeted end-run around Public Law 86-272 as New Jersey, the enactment of the Ohio CAT 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.

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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").

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 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

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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

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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 and use taxes.[30] Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.[31]

III. OTHER CONSIDERATIONS

A. *FEDERALISM*

Contrary to the arguments of some opponents of clarifying the standards for state business activity taxes,[32] considerations of federalism support passing this legislation. A fundamental aspect of American federalism is that Congress has the authority and responsibility to ensure that interstate commerce is not burdened by state actions (including taxation of such commerce).[33] The Founding Fathers, by discarding the Articles of Confederation and establishing a single national economy, intended for Congress to protect the free flow of commerce among the states against efforts by individual states to set up barriers to this trade. Congress itself has recognized this numerous times in the context of state taxation and has exercised its responsibilities repeatedly by enacting laws that limit the states' authority to impose taxes that would unreasonably burden interstate commerce.[34] Some critics argue that such

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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).

[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*, 968 So. 2d 18 (AL Ct. Civ. App. 2006)).

[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

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measures are too restrictive and violate principles of federalism.[35] No one disagrees that tension exists between a state's authority to tax and the authority of Congress to regulate interstate commerce. However, the very adoption of the Constitution was itself a backlash against the ability of states to impede commerce between the states; in adopting the Constitution, which expressly grants Congress the authority to regulate interstate commerce, the states relinquished a portion of their sovereignty.[36] Moreover, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[37]

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

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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.

[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.").

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, 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

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[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.

[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.

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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 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

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).

[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).

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 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.

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[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).

[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).

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 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

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[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.

[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.

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.

Sincerely,

Arthur R. Rosen
McDermott Will & Emery LLP
340 Madison Avenue
New York, NY 10173
Counsel, Coalition for Rational and Fair Taxation

The Computing Technology Industry Association

Testimony Before the

Subcommittee on Commercial and Administrative Law

House Judiciary Committee

"H.R. 1439: The Business Activity Tax Simplification Act of 2011"

April 13, 2011

Introduction.

Good afternoon, Chairman Coble, Ranking Member Cohen, 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 Coble 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. CompTIA respectfully urges prompt enactment of H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA").

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 about 3000 small computer services businesses called Value Added Resellers (VARs), as well as most major computer hardware manufacturers, software publishers, and service providers. Likewise, we are proud to represent the American IT worker who relies on technology to enhance the lives and productivity of our nation.

The Issue.

As states seek to maintain or expand both their tax bases and collections, we note ever-increasing attempts by state taxing authorities to tax interstate transactions.

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As established by the U.S. Supreme Court, the principle requirement allowing a state to require a non-resident business to collect and pay over sales and use taxes is "*physical nexus*." In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court ruled that a state is not permitted to require a non-resident seller to collect and remit sales and use taxes, unless that seller has a *physical presence* in the state. Therefore, a business that resides in State A cannot be required by State B to collect and remit sales taxes on sales made to customers in State B, *unless that business has a real physical presence in State B*. Commonly, *physical presence* has been interpreted as having an office or place of business in the state, or employing workers that operate within the state.

One of the basic principles of the *Quill* decision is fairness. That is, it is principally unfair and burdensome for a state to require a business to collect sales and use taxes when that business has no physical presence in the taxing state. The need for this emphasis on fairness , as established in the *Quill* decision, 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 an unbearable 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 "new" theory some states have attempted to tax any transaction that has an *economic nexus* to that state. *This is bad tax policy that will result in unmanageable tax and compliance problems for all businesses -- especially small businesses.*

Imposition of business activity taxes under the *economic nexus* theory imposes a particularly burdensome regime on the IT industry. For example, a VAR located in State A is engaged by a customer in State B to solve a software issue. The VAR has no place of business in State B and has never visited State B; but, without ever entering State B, the VAR connects to the customer's computer via the Internet, the computer is repaired, and the customer is billed for this service. Under the *economic nexus* theory, State B could assert that income earned by the VAR is subject to income and franchise taxes in State B. Also, because the VAR is a resident and is physically present in State A, State A would likewise seek to tax these earnings.

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.

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.

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Legislation.

Accordingly, we call on Congress to pass H.R. 1439, the "Business Activity Tax Simplification Act of 2011" 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 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.

CompTIA
April 13, 2011

Before the
House Judiciary Subcommittee on Commercial and Administrative Law

Hearing on "HR 1439 – the Business Activity Tax Simplification Act of 2011"

April 13, 2011

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

Chairman Coble, Ranking Member Cohen and Members of the Subcommittee, on behalf of the Consumer Electronics Association (CEA), thank you for the opportunity to submit written testimony concerning state taxation nexus issues.

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

Our more than 2,000 members are involved in the design, development, manufacturing, distribution and integration of audio, video, in-vehicle electronics, wireless and landline communication, information technology, home networking, multimedia and accessory products, as well as related services that are sold through consumer channels.

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

I appeared before this same Subcommittee three years ago on the levying of business activity taxes by certain states on companies that lack a physical presence in said state, and presented clear evidence on the critical impact it is having on businesses across our country. I regret to report the problem has only worsened since then. In 2008, I detailed how American businesses faced a host of new problems, from skyrocketing energy costs to the uncertain availability of investment capital. Today in 2011, I need not spend much time detailing challenges still facing American businesses as our country continues to regain its economic footing.

But now this Subcommittee has a rare but real opportunity to help struggling businesses across our country: stop individual states from using dubious "economic nexus" theories to levy income and franchise taxes against companies that have customers but no physical presence in

the taxing state. These taxes harm businesses – especially small businesses, and violate the U.S. Constitution by unduly burdening the free flow of interstate commerce. On an everyday level – beyond questions over the constitutionality of such a practice, these taxes cause massive compliance costs – especially for small business, when these funds would be better put to use towards the hiring of additional workers or investing in new technologies that will grow their individual business and the American economy as a whole.

Without such a clarification by Congress or the U.S. Supreme Court, businesses will continue to face an unclear business environment with no way of estimating where and when they will be taxed, and business expansion is chilled as a result. Companies will also face the risk of duplicative taxation, as they also pay increasing legitimate taxes to the states in which they are domiciled.

It is time for Congress to step in and assume its constitutional responsibility to ensure that commerce is not harmed by unfair taxation. CEA strongly supports H.R. 1439, the Business Activity Tax Simplification Act of 2011, which would provide the much needed relief to American businesses. We applaud the leadership of Representatives Bob Goodlatte (R-VA) and Bobby Scott (D-VA) in introducing this important legislation. H.R. 1439 will provide clarity by providing a bright line definition of physical presence. Most importantly, it will provide relief to businesses by clearly preempting states from taxing corporations with no physical presence.

Our members are good corporate citizens, and we are not asking for relief from legitimate taxation. We are asking to restore a simple principle: a tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer. H.R. 1439 provides that only businesses receiving state and local benefits derived from such taxation like education, transportation, fire and police, should be subject to such taxes. Furthermore, the legislation will not impact states' ability to collect income or other legitimate taxes from its residents.

Therefore, I respectfully urge you again to say no to taxation without representation and mark-up and pass the Business Activity Tax Simplification Act of 2011.

Thank you.

Officers, 2010-2011

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R. Paul Weatherford
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James R. Williams
Massachusetts Mutual Life Insurance Co.

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(202) 484-5225
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April 13, 2011

VIA EMAIL

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on the Courts, Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

Re: Hearing on H.R. 1439, the "Business Activity Simplification Act of 2011"

Dear Chairman Coble and Ranking Member Cohen:

Thank you for the opportunity to submit this statement for the record for the April 13, 2011 hearing on H.R. 1439 on behalf of the Council On State Taxation (COST). COST strongly supports H.R. 1439 and encourages you to move it swiftly through the Subcommittee.

About COST

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 equitable and nondiscriminatory state and local taxation of multistate business entities.

BAT Nexus Needs Congressional Action

Our comments address two fundamental questions at hand:

1. Why does the issue of Business Activity Tax (BAT) nexus warrant Congressional action?
2. Why is physical presence the appropriate standard for BAT nexus?

The first, and perhaps the most important determination a business must make with regard to state business activity taxes is whether the business is actually subject to tax at all in a particular state. That is, does the business have "nexus" with the state? The threshold is governed by the United States Constitution's negative Commerce Clause, which prohibits states from unduly burdening interstate commerce. Taxing businesses with only limited links to a jurisdiction has long been considered a burden on interstate commerce because of the high compliance costs associated with the taxation of such fleeting or nominal activity. It is not an exaggeration to note that since the first state business activity tax was imposed, taxpayers have never been certain as to what activities will be subject to taxation by a state or municipal jurisdiction.

The United States Supreme Court has offered some guidance and at least one bright line rule as to the requisite level of activities sufficient to subject a business to state's tax without creating an impermissible burden on interstate commerce. In the Court's 1992 *Quill* decision, *Bellas Hess* was reaffirmed and the Court retained its bright line rule that a state cannot impose a sales tax collection liability on a seller that does not have a physical presence in a state. From Congress' perspective, however, *Quill* was additionally a seminal refinement of the Court's earlier jurisprudence, because for the first time it noted a distinction in the concerns underlying the Due Process and Commerce clauses of the Constitution. As part of that distinction, the Court clarified that Congress may legislatively set the jurisdictional standard governing states' ability to impose tax burdens on interstate commerce. Indeed the Court *invited* Congress to legislate in the area of nexus for state tax purposes, stating: "[O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but one that Congress has the ultimate power to resolve."

In absence of Congressional action following the Court's decision, states (and municipalities) have become increasingly aggressive in attempting to assert tax jurisdiction over interstate commerce. These efforts to reach companies with minimal or no physical presence in a state have led to litigation in state courts with mixed results – not unexpected given the lack of clear guidance from either Congress or the United States Supreme Court. Conflicting state laws and court decisions create tremendous uncertainty and expense for taxpayers. Multistate businesses are deeply concerned both by this uncertainty and efforts by the states to impose tax on businesses that do not have physical presence in a state, thereby burdening interstate commerce and limiting cost-effective market options. Surveys of the COST membership consistently demonstrate that this issue is the multistate business community's number one concern regarding state tax policy.

The uncertainty created by conflicting interpretations of the Constitutional standard for tax jurisdiction has long resulted in unnecessary administrative and litigation expense for both taxpayers and states, and will certainly continue to increase the costs and risks of operating a multistate business in the future. For example, the Financial Accounting Standards Board Accounting Standards Codification 740-10 ("ASC 740-10") of its Statement 109 (Accounting for Income Taxes) shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards. ASC 740-10 appropriately seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes.

Unfortunately, the lack of any definitive, national authority for state tax jurisdiction complicates the analysis under ASC 740-10 and creates an ongoing dilemma for multistate companies. For example, if a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment may never expire. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence level ("more likely than not") on the validity of its financial statement reporting position under ASC 740-10. As a result, this phantom tax liability imposed by the state (plus accrued phantom penalties and interest) will never disappear from the financial statements unless the business is actually audited and the state determines that in fact, it does have nexus. This is but one example of how current uncertainty over the scope of the nexus requirement creates confusion beyond the immediate and apparent tax effects.

Congress, accordingly, with plenary authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but also serves as the measure of last resort for the courts and for multistate companies on this issue.

Physical Presence is the Appropriate Standard

It is COST's position, in order for a state or municipality to impose business activity tax on an entity, that a business must have a physical presence in the jurisdiction. Congress must recognize physical presence as the jurisdictional standard for business activity taxes. Physical presence should be defined to include quantitative and qualitative *de minimis* thresholds. Congress must also prohibit unreasonable attribution of nexus. Finally, Congress must preserve and modernize P.L. 86-272.

Determination of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens – economic and 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 benefits or protections from the jurisdiction, should not be required to pay tax to that jurisdiction. Such a test also delineates a clear line to guide both businesses and the states (including their localities) on when a business can be subject to a State's tax.

Congress must exercise its authority under the Commerce Clause to recognize physical presence as the nexus standard for business activity taxes. In doing so, Congress should include a *de minimis* threshold based on the temporary presence of employees, agents and property in the State. Congress should also modernize P.L. 86-272 by including services and intangibles in the scope, extending its application to all direct taxes, extending its coverage to activities subject to local taxes, and clarifying its definition of independent contractor.

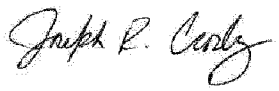
Opponents of a physical presence nexus standard misconstrue the burdens on business that a lower threshold would invite the global economy in which we now live. In prior testimony before the Senate, the Multistate Tax Commission (MTC) argued that "sound economic policy requires the adoption of...economic nexus as the standard for the application of state and local taxes." Nothing could be further from the truth. No tax treaty, to which the United States is party, recognizes such a low threshold for tax jurisdiction. This raises further questions: What is economic nexus? Is it where a business has a customer? A website? An account receivable? Under an "economic nexus" theory, companies would lose any ability they currently have to support states that provide a favorable business tax climate, and states would lose any incentive to provide such an environment.

Indeed, some former tax administrators have recognized the problems inherent in an economic presence nexus standard. A former MTC Executive Director, Eugene Corrigan, has argued "that the states need to face the reality that most of them are generally incapable of enforcing the "doing business" [economic presence] standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and efforts via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best."

Conclusion

In 1992, the Supreme Court invited Congress to legislate in the arena of nexus. Nearly twenty years later there has yet to be Congressional action on this matter. Once again, in 2011, Congress has the opportunity to properly construct a bright-line physical presence nexus standard that will promote fairness, eliminate uncertainty for both the business community and states, and significantly reduce the frequency and costs of litigation. Toward that end, COST respectfully requests swift and favorable action on H.R. 1439.

Sincerely,



Joseph R. Crosby

cc: COST Board of Directors
Douglas L. Lindholm, President & Executive Director, COST

Letter of Support by Mark B. Wieser
Founder of Fischer & Wieser Specialty Foods, Inc.
For passage of
H. R. 1439, The Business Activity Tax Simplification Act of 2011

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

Chairman Coble, Ranking Member Cohen and Members of the Subcommittee, I would like to commend you for holding a hearing on H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA"), and respectfully urge that you immediately mark-up and favorably report the bill out of the House Judiciary Committee. The enactment of BATSA into law is urgently needed by our company, and all others doing business in interstate commerce.

I am the founder and chairman of the board of Fischer & Wieser Specialty Foods, Inc., located in the small Texas county of Gillespie, the same county that has produced two outstanding Americans: Fleet Admiral Chester W. Nimitz, Commander-in-Chief of the Pacific Fleet during World War II, and President Lyndon B. Johnson.

Our company was founded in 1969, as a roadside market that I named das Peach Haus, to sell the area's delicious and famous "Fredericksburg Peaches." To supplement my market I asked my mother make her home-made jams and jellies for me to sell, and I discovered within a few years that there was a growing market for her "home-made" goodness. In 1986, with a former student, Case D. Fischer, who had worked for me all through his high school years, we incorporated the business and began marketing jams, jellies, mustards, salsas, and sauces to the wholesale trade, to up-scale department chains, and to gourmet stores under the **"Fischer & Wieser"** brand.

To give ourselves exposure we began participating in and attending area, state and, eventually, national shows. Mr. Fischer began to apply the skills he learned while

studying Food Science at Texas A & M University and began developing new products by combining different fruits with the Chipotle pepper. Sampling and participating in local events and fairs convinced us that we had developed a new and exiting flavor to introduce to Americans. (We were the first to introduce the chipotle pepper to the American palate.)

As members of the **National Association of the Specialty Food Trade** (NASFT) we were permitted to enter new products into national competition if nominated and recognized by a sufficient number of members of the retail trade. In New York City, in 1997, we won the highest national award given by the NASFT for our new **Original Roasted Raspberry Chipotle Sauce™**. It was nominated for being the best selling product for that year. Since 1997, it continues to be the best selling condiment in the United States. In other words, it is a product that sells, if simply sampled by retailers. In fact it flies off the shelves. (I personally, have sold over 23 cases (276 bottles) in a single afternoon at stores belonging to national chains (Whole Foods) simply by offering a taste to passing shoppers.)

Today, Fischer & Wieser Specialty Foods, Inc. sells to retailers in all fifty states, throughout Mexico, to parts of Canada and Australia, and our first container will be shipped to the United Kingdom in March. We have also exported to Germany and Taiwan from time to time. We sell to all the major national food chains, including Costco, Sams, Kroger, Safeway and a host of regional, up-scale groceries. By 2005 Fischer & Wieser products had captured 2.7% of the national specialty marinade market for companies having more than ten million in annual sales.

We employ approximately seventy-five employees and are the largest privately-owned business in our small town. Our weekly payroll injects over forty thousand dollars into our local economy. Unfortunately, what most people do not understand about food manufacturing is that the margin (profit) is very small. In the grocery trade, **net profits** near 3% are considered excellent.

In the recent decades some states, now including Texas, have resorted to applying taxes based on **gross sales.** Gross Sales vs. Net Sales, what is the difference? Well what law makers do not understand is that a 1% tax on "gross sales" is equivalent to a state taking **one third** of our "net" profits. The lower the net percentage, the larger the state's share. (Texas' Franchise tax is applied on gross sales even when a company posts a net loss.)

Our introduction to the Business Activity Tax Nexus issue was sudden and came as a complete surprise. I have to admit, I had never even heard of the term until 2007, when the company received a questionnaire from the State of Washington, asking if we were selling products there, if we had visited anyone in the state, and a number of other questions that we thought were for the purpose of completing a survey. We completed the form and returned it. There was no indication whatsoever in that questionnaire that the State of Washington was going apply a tax on our sales. Given that our company has never had a physical presence in Washington, we were quite shocked when we were assessed more than $15,000.00 in taxes and penalties for the previous five years, merely for selling to businesses headquartered in that State.

We paid the taxes that were assessed, and I began to research what Nexus was all about. Meanwhile, we appealed the decision, submitting numerous court cases that supported our case to the Washington Department of Revenue. We had a final hearing in March. An attorney, familiar with the state of Washington's interpretation of laws, however, had told us not to expect to win and for us to consider taking the state to court would cost more than the amount of money we are asking to be returned. Additionally, I had read that over 10,000 appeals to the Washington Department of Revenue have been made by companies, such as ours, suddenly finding themselves subject to Nexus laws. I had found no reversals up to our hearing, as its rulings were based on laws passed by the Washington legislature, and the Washington Department of Revenue repeatedly had ruled that it was not permitted to overrule the legislature. I had also found that they consistently ignore all federal laws.

We based our appeal on **PL 86-272** after reviewing numerous court cases that have dealt with Nexus issues. We felt confident that we would not be subject to Washington taxes as we had established no **physical presence**. To support our appeal, we submitted no fewer than three dozen typical examples of activities (none of which we performed) that are typically cited to support a state's claim towards establishing Nexus. We asked the State of Washington what they were using to support their claim that Nexus had been established. Unfortunately, we soon discovered that those things that normally establish Nexus did not matter, for the state of Washington felt it had no obligation to comply with PL 86-272.

We had our hearing before the Board in March of 2010 and, after giving sworn testimony, rested our case. A month later, the ruling came down, and we had won! The Department appealed, and we submitted additional written testimony. Again, the Board ruled to uphold its decision. It was a first! The Department refunded all our money with interest.

While we won, we know that other companies are still at risk, and this bill simply must be enacted into law or more and more American businesses will fall victims to unbridled states seeking revenues where ever they can find them.

The only in-state activity acknowledged by Fischer & Wieser Specialty Foods, Inc. on the State of Washington questionnaire was to acknowledge that we had sent a representative, as a courtesy, to call upon a distributor headquartered in the State. In all the cases that we cited in our defense, such an activity had been shown in case after case not to be sufficient to confer Nexus. The State of Washington has, however, made it quite clear that, in their estimation, the sending of a representative into their State, no matter if only for a single hour, is sufficient to establish Nexus for the assessment of income-based tax. In addition, the State claimed that we must be sending a representative into the jurisdiction to support and maintain our level of sales. This assertion is nonsense and simply not true. We have a product that taste alone sells! We are far too small a company to develop marketing plans for any state.

Additionally, Washington has made it quite clear that it considers its tax a **Business and Occupation Tax (B&O)**, and consequently argues that it is not a tax covered by PL 86-272. Specifically, the State says that PL 86-272 applies only to states that have enacted a **"Net"** income tax. Since the state of Washington has a "Gross" income tax their argument is that they are not subject to the requirements of PL 86-272. As you may know, at the time that PL 86-272 was passed, few states had taxes based on "net sales." It did not necessarily take a Philadelphia lawyer for these states to figure out that if they modified their tax laws to apply to "gross sales," they could completely avoid PL 86-272. Just like little kids, states discovered new ways to avoid PL 86-272. This has become a game, and it has caused significant problems that only Congress can resolve. The courts have consistently refused to resolve this problem, for most recognize the role that Congress should play in this matter. Fischer & Wieser Specialty Foods, Inc. and hundreds of small companies across the land simply cannot afford to hire attorneys to take states, such as Washington, to court to force them to abide by the intent of PL 86-272. That is why we so strongly recommend enactment of **BATSA**.

Incidentally, in my research I have discovered that the state of Washington is also of the opinion that it has the right to assert Nexus if the driver of a **common carrier** delivering product does not have the explicit authority to inspect and to reject products the driver may deem to be of questionable quality. This is just one more example of how states have circumvented the intent of federal law. What common carrier in this nation would accept or assume such responsibility?

The state of Washington has also said that they have the right to inspect our books and that we are required by its laws to keep accurate records of all shipments and to have such records available at all times and in compliance with its laws. While we have employed an independent outside audit of our books for more than a decade, we simply cannot afford the additional expense to keep separate books for every state. To comply with all laws required by the state of Washington would force us to comply with the laws of all fifty states and every taxing authority within those states. I understand that this

could reasonably be determined to be more than 3,200 individual and separate taxing entities! For large companies this might be possible. For small companies this becomes an unbearable cost of doing business.

Additionally, our largest customer in the state of Washington serves as the regional headquarters for the northwestern division of Costco. It acts as the buyer for all its stores located in the States of Oregon, Idaho, Montana, Alaska and Hawaii. The State of Washington insists it has the right to tax products delivered directly to other states outside the State of Washington simply because Costco's regional office is located there. We have no way of knowing where Costco places our products or whether or not our products cross into Washington before being delivered. Consequently, we very likely are paying taxes on products that were never actually sent into that state. The consequences of this, if followed by every state, would destroy commerce in the United States.

Beginning in 2009, in an effort to avoid a claim of tax due to Washington for 2009 and years thereafter, I ordered our representatives not to enter the State of Washington. The State of Washington accepted that commitment, but advised that its laws provide that Nexus, once established, is deemed to remain in effect for five years.

Incidentally, the initial order by the Northwest Region of Costco was not the result of a sales call made by our company to the state of Washington. Fischer & Wieser Specialty Foods, Inc. first began selling to other regional divisions of Costco after their buyers called on our booth at the NASFT. NASFT national shows occur only in January or February on the west coast, normally in San Francisco, and on the east coast in June or early July, always in New York City. It was our product's ability to produce outstanding sales in the Southwest Region of Costco that caught the attention of other Costco regional offices. The Northwest Region began to send its first orders and subsequent orders directly to our company offices in Texas upon their own initiative and without any Fischer & Wieser Specialty Foods, Inc. representative calling upon that region.

Fortunately, the State of Washington is the only state where we are not physically present that has actively sought to tax us; however, we realistically face similar taxes from all other states if BATSA does not become law. We simply cannot afford to continue to operate if we are not protected from arbitrary and unscrupulous interpretations of Nexus by the various states. The same fact holds true for thousands of small companies across this nation.

I can assure you, if Fischer & Wieser Specialty Foods, Inc. had offices, property or employees in any state other than Texas or enjoyed the protections and benefits provided by the legislature of any other state, we would willingly and understandingly pay our fair share of taxes due to that state. But, for a business to be subject to state income tax based on a whim does not contribute to the economic success of this nation.

Fischer & Wieser Specialty Foods, Inc. is asking Congress to enact **BATSA**, a bill that will clearly spell out what will establish Nexus, thereby freeing small businesses from the unnecessary costs incurred in by the need for constant court cases and appeals. Many of us thought that all the issues relating to commerce between the states had all been resolved when the Articles of Confederation were set aside in favor of a new Constitution. It had become so very clear and so thoroughly understood by those who believed in forming a better and more perfect union that this nation could not grow strong if each state restricted the exercise of a national free trade. Those patriots understood the problem and resolved the problem. I am simply asking that this Committee clarify the physical presence nexus standard and once again strengthen and guarantee forever the principle of free trade between the states.

We pray that this testimony is helpful and beneficial to the Subcommittee. Thank you.

Sincerely,

Mark B. Wieser

Mark B. Wieser, Chairman
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Statement of David Rolston, President and CEO of Hatco Corporation, on behalf of the North American Association of Food Equipment Manufacturers

Submitted to the Commercial and Administrative Law Subcommittee of the House Judiciary Committee, April 13, 2011

Re: Hearing on H.R. 1439: The Business Activity Tax Simplification Act of 2011

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. 1439, The Business Activity Tax Simplification Act of 2011.

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. 1439, 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. 1439 would serve this purpose.

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 Howard Coble, Chairman
United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

April 13, 2011

Chairman Coble and Members of the Committee: Thank you for the opportunity to provide testimony relevant to your hearing on H.R. 1439: the Business Activity Tax Simplification Act of 2011.

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 have been 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 2011 (H.R. 1439) ("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.

Subject: Testimony of Ivan Petric, Vice-President, Hope Trucking, Inc.

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 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

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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.

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.

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

April 13, 2011

The National Association for the Specialty Food Trade, Inc. (NASFT) is pleased that the Subcommittee on Administrative and Commercial Law is holding a hearing on H.R. 1439: The Business Activity Tax Simplications Act of 2011. The issue of business activity tax nexus 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, clarify 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. 1439, the Business Activity Tax Simplification Act of 2011.

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 H.R. 1439, 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 have been 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 2,900 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 $2,306,000 in annual sales and, although small, markets 51 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 H.R. 1439: The Business Activity Simplification Act of 2011. Defining nexus ***is*** the role of Congress.

NATIONAL FOREIGN TRADE COUNCIL, INC.

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Comments of the National Foreign Trade Council
On the Business Activity Tax Simplification Act (H.R.1439)
Before the House Judiciary Courts, Commercial and Administrative Law Subcommittee
On April 13, 2011

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. 1439, the Business Activity Tax Simplification Act of 2011, ("BATSA"), and respectfully asks that you support the bill and schedule it for a markup.

H.R. 1439, a bill introduced by Representatives Bob Goodlatte (R-VA) and Bobby Scott (D-VA), has strong bipartisan support among members of the Judiciary Committee. The bill would clarify the constitutional nexus standard governing state assessment of corporate income taxes and other direct taxes on a business (it 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 Courts, Commercial and Administrative Law Subcommittee on the Business Activity Tax Simplification Act.

NeutralPosture

April 13, 2011

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

Re: Hearing on H.R. 1439, the Business Activity Tax Simplification Act of 2011

Dear Chairman Coble and Ranking Member Cohen:

I am Rebecca Boenigk, CEO and Chairman of Neutral Posture. Thank you for the opportunity to submit this written testimony in support of H.R. 1439, the Business Activity Tax Simplification Act of 2011. I applaud you for holding a hearing on this bill and respectfully urge you to quickly report it out of the House Judiciary Committee.

I founded Neutral Posture in 1989 with my mother, Jaye Congleton. Our company manufactures ergonomic seating products and accessories for the office, lab and manufacturing areas. Neutral Posture is the only woman-owned seating manufacturer in the United States and is a certified women's business enterprise (WBE). The company is one of the top diversity suppliers for the United States government and Fortune 500 companies worldwide. Currently, we employ 62 people in Texas and five in Canada.

Although Neutral Posture is physically present only in Bryan, Texas and Chicago, Illinois, we have been assessed income-based taxes by California, Florida, Georgia, Indiana, Minnesota, Ohio, Pennsylvania and Washington, based on sales we have made to customers located in those states. While we do make use of the services of independent sales representatives in every state in which we have customers, those individuals are not employees of Neutral Posture, and they service many companies besides ours.

3904 N. Texas Ave., Bryan, TX 77803 T 979.778.0502 F 979.778.0408 • NeutralPosture.com

NeutralPosture

Of course, our sales representatives located in other states do pay income taxes on their own business profits in their own states, just as we pay income taxes in Texas and Illinois. We do not object to paying taxes in states where we have a presence and receive government services. We do object to paying business activity taxes to states where we have no physical presence.

It is impossible to run a business not knowing what jurisdiction next will send us an assessment for income-based taxes. Nor does a smaller business, like ours, have the means to fight such unfair assessments through costly and protracted litigation. When forced to pay business activity taxes to a state where we have no physical presence, we are forced to make a choice between passing such costs on to our customers and taking a hit to our bottom line.

The Business Activity Tax Simplification Act (BATSA) codifies the traditional physical presence nexus standard, meaning that a state or locality cannot impose a business activity tax on a business unless that business has a physical presence (such as employees, an office or real property) in the state for more than fourteen days in a taxable year. The bill establishes a bright-line standard that will eliminate confusion for both state tax administrators and businesses, resulting in less litigation, fewer nexus audits, less tax compliance guesswork and, thus, greater investment in business growth and jobs. Enactment of the bill is crucial to our company.

Thank you again for your attention to this very important issue.

Sincerely,

Rebecca Boenigk

Rebecca Boenigk

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NYBA

STATEMENT OF THE NEW YORK BANKERS ASSOCIATION

BEFORE THE HOUSE SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

COMMITTEE ON THE JUDICIARY

ON H.R. 1439, THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

April 13, 2011

The New York Bankers Association appreciates the opportunity to submit this statement for the record of the hearing of the Judiciary Committee's Subcommittee on Commercial and Administrative Law on H.R. 1439, the Business Activity Tax Simplification Act of 2011. The New York Bankers Association strongly supports this legislation that would clarify and modernize the rules governing a state's ability to impose income taxes on companies that have no physical presence in the state. Our Association is comprised of the community, regional and money center commercial banks and savings institutions doing business in the State of New York. Our members hold aggregate assets in excess of $9 trillion and employ more than 250,000 New Yorkers.

This legislation will clarify that states may not tax out-of-state intangible property or services. Current law clearly precludes state taxation of out-of-state tangible personal property and real estate. The bill will also require that an entity have a physical presence in a state in order to subject the entity to the state's taxing jurisdiction. The bill sets forth criteria for determining whether a physical presence exists.

This legislation will clarify situations in which a state can constitutionally tax out-of-state corporations. It is particularly important for a State like New York that sells vast amounts of financial services in other states. The physical presence standard contained in the bill is one that the United States Supreme Court has recognized as an appropriate nexus for state taxation.

In recent years, an increasing number of states have enacted legislation taxing business activities that occur outside their physical jurisdiction and that bear only a remote relationship to the taxing states. In the financial services arena, these enactments have largely focused on taxing loan and investment relationships entered into by residents of the taxing states with non-resident business entities whose only relationship with the taxing state is the use of instruments of interstate commerce, such as the Internet, the United States Postal Service and the telephone to transact business with their customers. These states have been characterized as "market states," because they attempt to tax the market for goods and services, rather than the physical entity that provides the goods or services.

This system of taxation is clearly a burden on interstate commerce and falls squarely within the jurisdiction of Congress to address. The home states of companies being taxed by market states already tax the profits of these companies, resulting either in double taxation or in a reduction in revenue for home states. With the increased reliance by customers on the Internet, the taxation of out-of-state residents and businesses will clearly become a more and more attractive means to enhance a state's revenue. It can therefore be expected that, without Congressional oversight, attempts to tax companies without a physical presence in a state will continue to increase.

H.R. 1439 draws a clear distinction between allowable and impermissible taxation by a state of the intangible activities of out-of-state residents and businesses. We strongly urge that the legislation be enacted.

ORGANIZATION FOR INTERNATIONAL INVESTMENT
INTERNATIONAL BUSINESS INVESTING IN AMERICA

Organization for International Investment ("OFII")
Written Statement for the Record of the House Judiciary Courts, Commercial and Administrative Law Subcommittee Hearing on H.R. 1439: the Business Activity Tax Simplification Act of 2011

April 13, 2011

The Organization for International Investment ("OFII") appreciates the opportunity to comment on H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA"). OFII urges the Committee to promptly mark-up and favorably report out BATSA 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 5.6 million Americans — 4.7 percent of total U.S. private sector employment;
- U.S. subsidiaries account for 6 percent of total U.S. GDP;

- U.S. subsidiaries support an annual payroll of $408.5 billion — with average compensation per worker of $73,023, about one-third higher than compensation at all U.S. companies;
- U.S. subsidiaries heavily invest in the American manufacturing sector; with nearly 38 percent of jobs at U.S. subsidiaries are in manufacturing industries, accounting for about 16 percent of total American manufacturing jobs;
- U.S. subsidiaries manufacture in America to export goods around the world — accounting for more than 18 percent of all U.S. exports, or $232.4 billion;
- U.S. subsidiaries pay nearly 17 percent of total U.S. corporate tax payments, 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 percent of employees at U.S. subsidiaries compared to just 8.2 percent 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) Expanded "Water's Edge"

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 2009, West Virginia 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 certain U.S. sources. 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 West Virginia tax return and pay tax in West Virginia. 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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TESTIMONY SUBMITTED TO THE HOUSE JUDICIARY SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

HEARING ON H.R. 1439:
THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2011

Wednesday, April 13, 2011

KATHRYN WYLDE
PRESIDENT & CEO
PARTNERSHIP FOR NEW YORK CITY

Thank you, Chairman Coble 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.1439, the Business Activity Tax Simplification Act of 2011 ("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 taxable nexus varying from state to state, clarifying the physical presence requirement to articulate the bright-line nexus standard included in H.R. 1439 would alleviate the burden that many interstate businesses face and help promote economic growth across the country.

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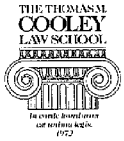
New York City is a major hub for interstate commerce and many New York-headquartered companies transact business in all fifty states and around the world. New York City and State incur huge expenses to supply the infrastructure and services necessary to accommodate these companies. Traditional practice 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.



MARJORIE GELL
ASSOCIATE PROFESSOR

April 12, 2011

Honorable Howard Coble
Honorable Stephen Cohen
Subcommittee on Courts, Commercial and Administrative Law
Committee on the Judiciary
517 Cannon House Office Building
Washington, DC 20515

Re: Hearing on H.R. 1439: The Business Activity Tax Simplification Act of 2011

Dear Chairman Coble and Ranking Member Cohen:

Thank you for your attention to the business activity tax nexus issue. Attached, please find an article titled "Back to the Future: The Hope for Enactment of BATSA Legislation," published in Tax Analysts in July 2009. I would like to submit the article for the record of your April 13, 2011, hearing on H.R. 1439, the Business Activity Tax Simplification Act.

Yours very truly,

Marjorie Gell

Marjorie B. Gell

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Back to the Future: The Hope for Enactment of BATSA Legislation

by Marjorie Gell

Last weekend was my 30th high school reunion. As part of the festivities, someone assembled a list of the memorable events of 1979. The shah was ousted from Iran and Iranian militants seized the U.S. embassy in Tehran and took hostages. The worst commercial nuclear accident in U.S. history occurred at the Three Mile Island nuclear power plant near Middletown, Pa. President Jimmy Carter and Soviet leader Leonid Brezhnev signed the SALT II agreement. Gas prices hit a then-record high of 85 cents a gallon.

This weekend I will attend my niece's high school graduation festivities. I can't help but wonder what events from 2009 will be remembered at *her* high school reunion, 30 years hence. The first African-American president of the United States is inaugurated. The world experiences the worst economic downturn since the Great Depression. The swine flu virus leads to a global pandemic. Is it possible that included on this list will be the historic passage of national nexus legislation for business activity taxes? The time seems ripe.

BATSA Legislation

The nexus legislation in question addresses the jurisdictional standard by which a state determines when an out-of-state business will be subject to a state's taxing authority. When and under what circumstances a state has jurisdiction to tax out-of-state businesses have historically been anything but clear. A patchwork of ever-changing and expanding standards exists throughout the United States, making it almost impossible for businesses to determine with certainty what activities or connections with a particular state will trigger tax. Unlike the permanent establishment standard that applies internationally, there is no a certain, clear, and uniform standard for state business activity taxes.

It has long been recognized that the only solution for stopping the never-ending wrangles over state nexus standards lies with Congress. Indeed, as there has been for the last several congressional sessions, there is pending legislation in the House of Representatives that would clarify when a business is subject to a state's business activity tax by creating a clear and uniform nexus standard applying to all business activity taxes in all states. The Business Activity Tax Simplification Act of 2009 — commonly known as BATSA — was introduced as H.R. 1083 on February 13 by Rep. Rick Boucher, D-Va. It enjoys wide bipartisan support with 17 cosponsors of the bill.

> ***There is no certain, clear, and uniform standard for state business activity taxes.***

BATSA as introduced would require that all states adhere to a clear physical presence standard applying to all taxpayers for all business activity taxes. Those taxes would include corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes. BATSA would ensure that physically present businesses that receive the benefits of state and local taxes (including the benefits of education, roads, fire and police protection, water, sewers, and so forth) would alone bear the business tax burdens. A business having minimal connection and not receiving the benefits and protections of that state would be assured that it is not subject to that state's business activity tax. That standard would prevent a business from being caught off guard by ever-changing and increasingly aggressive jurisdictional standards imposed by states across the country. It would reduce the uncertainty, confusion, and unexpected and exorbitant costs associated with defending a company from unfair tax assessments.

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The Boat Manufacturers

If one doubts the seriousness of the threat posed to U.S. multistate businesses by the absence of a federal nexus standard, one needs only to talk to members of the U.S. boating industry. Take Barry Godwin, controller of Stingray Boat Corp. He testified last year before the House Small Business Committee, urging the enactment of BATSA. During his testimony, Godwin related three nightmarish experiences that involved three different states — Maine, Washington, and New Jersey. Each of those experiences involved state assertion of nexus created by Stingray's inadvertent actions. Stingray had no offices, property, or employees in Maine, Washington, or New Jersey. Careful to stay within boundaries set forth by P.L. 86-272 (a federal law applying to state income taxes), Stingray filled orders from its offices in South Carolina, collected payment in South Carolina, and shipped the boats from South Carolina to out-of-state, independent dealers. It therefore neither filed returns nor paid any business activity or income taxes in Maine, Washington, or New Jersey.

All was well until 2006, when Stingray's run-ins with state revenue departments began. First was the revenue department from Maine, a state that claimed Stingray owed taxes retroactively to 2003 based on warranty payments the company made to independent dealers — payments on which the dealers would also have paid Maine income tax. Though Stingray itself did not do the warranty work, that it reimbursed its independent dealers for work performed on Stingray boats subjected the company to Maine income tax. According to Godwin, "I objected to the revenue agent, but we decided it would be less costly to pay the retroactive taxes and fines than to pursue the matter in the courts."

Did the New Jersey Department of Revenue's actions rise to the level of extortion?

Stingray's second experience, with Washington state, involved the assertion of business tax nexus based on the company's membership in the Northwest Marine Trade Association. Washington claimed that the membership established that Stingray maintained a market in the state such that nexus was created. Though Stingray joined the association primarily as a means of obtaining dealer discounts for boat show floor space, the company has since canceled its membership to avoid future nexus tangles.

While the Maine and Washington experiences are disconcerting, they pale in comparison to what happened to Stingray in New Jersey. According to Godwin, in 2007 he received a call from a New Jersey revenue agent informing him that a Stingray truck had been detained at a New Jersey weigh station and would be impounded if the company did not wire money by 1 p.m. that day. Godwin, on request of the revenue agent, looked up New Jersey sales from the past seven years and was informed that the amount that had to be wired was $46,200, representing jeopardy assessment taxes. Though the company had no outstanding legal issues with the state, nor any business activities in New Jersey aside from deliveries of boats to independent dealers, Stingray was forced to wire the money and appeal the matter later.

In his testimony, Godwin said:

> The manner in which the State of New Jersey acted is commonly defined as extortion. Fortunately, I have never been the victim of crime in my life. But, that day in July, I believe I was strong-armed by a state of the United States of America.

Did the New Jersey Department of Revenue's actions *really* rise to the level of extortion? The *Random-House Dictionary* defines extortion as "the crime of obtaining money or some other thing of value by the abuse of one's office or authority." Applying the term under these circumstances may be going a bit far, but it is not hard to understand how a company like Stingray might feel this way.

The Economy Begs for a Clear and Uniform Standard

No doubt, the experiences described by Stingray are not unusual, nor are the problems isolated to Maine, Washington, or New Jersey. Indeed, the condition of our nation's economy only increases the odds that more and more states will exploit the nonexistence of federally mandated nexus standards.

The Nelson A. Rockefeller Institute of Government recently reported that state income tax revenue dropped 26 percent in the first quarter of 2009, compared with the same period last year. It doesn't take much imagination to see what lies ahead. Once stimulus package funds run out and state programs are trimmed to the bone, there would seem to be little choice but to raise taxes. And what better source of those taxes than out-of-state businesses?

Think about it. State funds are needed. Desperately. Local governments can look within or look without to make up for lost revenue. Can anyone blame a state for venturing into neighboring states' backyards in search of funds to replenish the local coffers? State governments naturally act to further their constituents' best interests, even at the expense of the collective national marketplace. You know it. I know it. And the Framers of the U.S. Constitution knew it, too.

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Enter the commerce clause of the Constitution. Its original purpose to give Congress the power to protect the national marketplace, the commerce clause was put into place in part as a reaction to the patchwork of out-of-control fees and taxes imposed by states on incoming commerce. In the late 1770s, states were struggling to stay afloat amid losses in subsidies previously provided by the English government. Recognizing the existence of major confrontations among states regarding their discriminatory tax practices, which were not prohibited by the existing Articles of Confederation, the Framers adopted the commerce clause as part of the Constitution to give Congress the power to intercede when appropriate to protect the economic marketplace as a whole. Though Congress has used that power only occasionally in the state tax context — the most notable instance being the passage of P.L. 86-272 — it seems imperative that a clear and uniform standard be set for asserting state business activity taxes when states are struggling to breathe and the U.S. economy itself is on a ventilator. Businesses must have clear-cut assurance of when they will be subjected to a state's taxing jurisdiction. Congress has dragged its feet — as it has in so many other areas — for too long. The legislation continues to be reintroduced. The list of sponsors continues to grow. Now is the time for Congress to act as our forefathers did: with thoughtful consideration and appreciation of the devastating consequences of allowing states to erect barriers to interstate commerce. A clear, uniform, and definitive physical presence nexus standard applying to all states and all taxpayers would go a long way to ensure a healthy and stable national economy.

Parting Thoughts

As I ready to leave for my niece's graduation, my thoughts are with her, and my hopes are high. May the road rise to meet her. May the wind always be at her back. And may BATSA legislation be passed in her lifetime — at least by the time her 30th reunion descends upon her, and hopefully well before. ☆

As a Matter of Tax is a new column by Marjorie Gell, a tax professor at the Thomas M. Cooley Law School in Grand Rapids, Mich.

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WRITTEN STATEMENT OF

CAREY J. (BO) HORNE
PAST PRESIDENT
PROHELP SYSTEMS, INC.

and

KATHERINE S. HORNE
PAST VICE PRESIDENT
PROHELP SYSTEMS, INC.

on

"H.R. 1439, THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2011"

before the

SUBCOMMITTEE ON COURTS, COMMERCIAL AND ADMINISTRATIVE LAW

of the

COMMITTEE ON THE JUDICIARY

UNITED STATES HOUSE OF REPRESENTATIVES

April 13, 2011

Room 2141, Rayburn House Office Building

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-1439, The Business Activity Tax Simplification Act of 2011, 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.

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 **insurmountable** for most small businesses.
- Defend itself against an aggressive, far away state. Many of the claims made against small businesses are clearly unconstitutional, on multiple grounds. States are now regularly asserting claims for only de minimis activity in the state. They continue to pursue aggressively even the weakest cases because they know it is **virtually impossible** for small businesses to fight back.
- Finance the defense of an egregious claim all the way to the Supreme Court. The states are taking maximum advantage of a system that requires all tax cases, including those where substantial constitutional issues are involved, to exhaust all legal remedies within the state first. At that point, the only recourse is to the United States Supreme Court. Few, if any, small businesses will find this arduous route anything but **utterly impossible**.

Our Experience is *Not* an Isolated Case:

Our many conversations with people across the country show that abuses are far more common than generally recognized. At the time of my testimony in 2005, we were already personally aware of approximately fifteen small business victims located in multiple states, including three represented by members of the Judiciary subcommittee.

We did not search for these victims. Desperate for help, **they found us**, from testimony we submitted for the 2004 hearing or from numerous magazine and newspaper articles written about our case. Since the 2005 hearing, approximately fifteen **more** businesses have sought us out, also desperate for any help they can find for dealing with their crisis. One of the calls was from a small trade organization representing seafood processors; approximately twenty of their members in the Delmarva area had been trapped. When a tiny, **home-based** business learns of almost **fifty** small companies across the country faced with nexus nightmares, the true extent of the problem must be **enormous**.

We are completely flabbergasted that almost a dozen attorneys from across the country have also called us, trying desperately to learn as much as they can as quickly as they can, in order to provide adequate representation for their local clients fighting battles with far away states.

Each of the Judiciary Committee members should clearly understand that small businesses in ***your own States and in your own districts*** are ***already*** being wrongly burdened by greedy states, because we lack the vital protections every small business **assumes** already exist.

The Solution:

Some small businesses are not yet vocal with their support for the Business Activity Tax Simplification Act ("BATSA", HR-1439). They are generally totally unaware that numerous far away states are now taxing sales they implicitly assume are protected. Most are unaware that states are also now regularly ignoring or circumventing the basic protections granted by the Interstate Income Tax Act of 1959 (PL 86-272).

Most have no idea what nexus is, and don't really want to know. They just want to grow their businesses and help expand the Nation's economy. They have no idea that the sales they are regularly making across state lines, through a physical presence in their home state only, are exposing them to the same nexus nightmares many other small businesses have already encountered.

As the states employ more powerful and more pervasive systems to track the smallest sale made anywhere, small businesses will be regularly trapped like a deer in headlights, totally defenseless against what will soon occur, unless Congress uses its broad authority to protect the right of every small business to participate in Interstate Commerce on a reasonably unfettered basis.

Our personal experience, plus those of other small businessmen testifying to the House Small Business Committee on February 14, 2008, clearly show what happens when the standard leaves the smallest avenue open to abuse by greedy States. ***Without strong Federal legislation, small businesses will soon be unable to participate in Interstate Commerce, on any basis.***

The arguments about state sovereignty and how we must change our tax systems to accommodate the Internet economy are not reasonable for this debate. Small businesses have their backs to the wall. They now face the very situation that caused the Founders to give **you,** the Congress, the power to regulate Interstate Commerce. You **must** now use that power to protect our small businesses and even the entire National economy.

Only a **strong** restatement of the fundamental principles of physical presence will resolve the tragic and **impossible** consequences small businesses are facing. These principles worked so well for more than 200 years that they were simply "understood" and not even codified into law until the Congress did so with the Interstate Income Tax Act of 1959.

It is now **urgent** that this Congress modernize that Act quickly to protect our small businesses and our National economy. The Act must be expanded to cover all types of sales, both products and services, and it must prohibit all types of business activity taxes which are so harmful to the smallest of businesses.

Having faced this issue, up close and personal, for almost eight 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

Carey J. Horne
Past President

Katherine S. Horne

Katherine S. Horne
Past Vice President

ProHelp Systems, Inc. [2]
418 East Waterside Drive
Seneca, SC 29672

[1] Testimony and complete transcript of the hearing with Mr. Delahunt's comments 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 Administrative Law

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

IN SUPPORT OF H.R. 1956
"THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT"

September 27, 2005

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

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

In 1997, we sold one copy of our licensed software to a customer in New Jersey for $695. Because of this single sale, the State of New Jersey now demands that we pay $600 in taxes and fees, ***every year the software remains in use, even in years with no sales, and regardless of any profit.*** Despite two years of effort and substantial legal fees, New Jersey continues to press its claim.

Should all 50 States adopt New Jersey's Corporate Business Tax, small software developers selling just one license in every State would owe $30,000 in business activity taxes ***every year thereafter, with no additional sales anywhere***. Should localities follow suit, the results would truly be astronomical. These are powerful reasons to stay out of the software business.

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

The abuse is ***not*** limited to software. New Jersey even defies protections of the Interstate Income Tax Act of 1959 (P.L. 86-272), which prevents States from imposing income tax for Interstate activities where no physical presence exists. Today, if one of your constituents ships a box of paper clips to a customer in New Jersey, he will be subjected to the same tax.

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

The nightmares are certain to escalate. New Jersey increased its minimum tax ***150%*** in 2002. This tax is effectively borne only by the smallest participants in Interstate Commerce. The victims are generally not capable of fighting, they capitulate to reduce the risk of larger penalties, and they have absolutely no representation in the matter ***except right here***. Why should anyone believe this tax will not soon be increased again, and spread to other States? Without clear protections such as BATSA provides, aggressive States will always seek to stretch the limits and to impose their own creative definitions to justify taxation most citizens would consider unjust.

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

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

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

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

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

Additional Information:

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

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

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

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

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

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

(1) stop accepting all orders from New Jersey,
(2) have zero New Jersey income,
(3) terminate all existing software licenses, and
(4) have our customers remove all licensed software from their systems. We have been advised that we **cannot** terminate our nexus in future years by abandoning our license agreements and giving clear title of the software to our customers.

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

- We have terminated **all** of our national advertising. Our sales are down significantly as we attempt to refocus our activity into Georgia and South Carolina only.

- We have stopped accepting **all** orders from New Jersey locations. **We cannot accept any business, of any type, from New Jersey locations until small business is given the protection it must have in order to participate in Interstate Commerce on a free and unhindered basis.** In January 2004, we refused to accept a firm order for $15,000 of remote services from a Georgia customer who would have made payment through a New Jersey office. The risk of validating their claims of nexus **in future years** was simply too great for us to accept. Needless to say, this decision hurt our business badly.

- We have terminated all software licenses in New Jersey, and our customers have removed all licensed software and replaced it with new, unlicensed software. As a result, our intellectual property no longer receives the protection it must have in order to insure its viability for future enhancements and improvements and for our future income.

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

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

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

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

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

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

- **Small businesses**: Hopefully, we are sufficiently conveying why the passage of BATSA is so absolutely critical if small businesses are to participate in Interstate Commerce.

- **Large businesses**: Having worked for and with large businesses for many years, we understand and support their need for clarity and simplification of the rules which would allow them to devote more attention to delivering products and services instead of defending themselves in legal actions.

- **The States:** Why are they so strongly resisting BATSA?

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

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

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

(c) A possible threat to States' revenues arises from the **improper** use of intangible holding companies. If an intangible holding company licenses intangible property to an unrelated company, then it **should** receive the protection the physical presence standard provides. If the intangible holding company operates only to avoid taxation, without other legitimate business purposes, the States have several remedies they have traditionally employed to prevent loss of income; and many States have already enacted one or more of them. So, this issue is no reason to avoid prompt passage of this bill.

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

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

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

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

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

Because physical presence was intended to be the current standard, BATSA would neither diminish the taxing powers of state and local jurisdictions nor reduce state and local tax revenues. It will allow

businesses to concentrate on growing our economy and providing jobs, instead of arguing legal points at great cost, by ensuring no undue burdens hinder Interstate Commerce.

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

Carey J. Horne, ProHelp Systems, Inc.

Carey J. "Bo" Horne is President of ProHelp Systems, Inc., a software development firm located in Seneca, South Carolina. Founded by him in 1984, ProHelp designs, develops, and markets highly complex and specialized product configuration, engineering, and manufacturing software systems for major electrical equipment manufacturers. Engineering software developed by ProHelp has been designated as "best in our world-wide organization" by a large, multi-national manufacturer. ProHelp also creates systems integration software for midrange and mainframe markets, including printing and communications utilities used by programmers throughout the world.

Bo began his career with the Cutler-Hammer products group of Eaton Corporation and held various management positions in engineering, materials, manufacturing, and information technologies within the Industrial Control Group. With a strong background in all disciplines of plant operations, he is an acknowledged expert in Motor Control Centers and has developed comprehensive engineering software for three of the top five manufacturers. He developed the industry's first product configuration system for Motor Control Centers provided directly to architects, design engineers, and electrical distributors.

He is a summa cum laude graduate of The Georgia Institute of Technology with a degree in Electrical Engineering.

April 11, 2011

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act

Dear Chairman Coble and Ranking Member Cohen:

I am Joan Maxwell, President of Regulator Marine, Inc. I am submitting this testimony to thank you for holding a hearing on the business activity tax Nexus issue and to urge your support for the Business Activity Tax Simplification Act of 2011 ("BATSA"), H.R. 1439.

Incorporated in 1988, Regulator Marine is an Edenton, North Carolina based manufacturer of sport fishing boats ranging in size from 23 – 34 feet. These boats are sold exclusively through a dealer network in both the United States and Europe. (Regulator does not sell to consumers/end users). The company ships over land to its domestic dealers or to ports by either contract carriers or Regulator's truck and trailer.

There is one state that I am aware of that has a reputation (in the marine industry) for stopping loads and holding them until Nexus taxes are paid. As a small company, Regulator can not afford to risk boats not reaching their destination in a timely manner. Small businesses like Regulator literally operate off of cash flow. To mitigate some of the risk of stopped loads, Regulator ships on contract carriers in this state when use of its own equipment would be less expensive.

BATSA would provide for a consistent, national jurisdictional standard for the imposition of state and local business activity taxes on interstate commerce. This is one of the most significant measures affecting interstate commerce and the growth of American small businesses.

The business activity tax nexus issue is a significant priority for Regulator Marine, Inc. The issue relates to the circumstances in which a state may properly assess an income-based or similar tax against a non-resident business. Traditionally, the states and the courts accepted the historic principle that a business must have a "physical presence" in a state before that state may assess such tax. More recently, however, some states have

187 Peanut Drive, Edenton, North Carolina 27932 • 252-482-3837 • www.regulatormarine.com

abandoned the traditional physical presence nexus standard and have attempted to assert a right to tax non-resident businesses based on a theory called "economic nexus," which claims authority to tax the income or gross receipts of companies who have merely customers, but no physical presence, in the taxing jurisdiction.

Such efforts by states to unconstitutionally expand their taxing authority have led to unfairness and uncertainty, increased compliance costs, hindered business expansion, put companies at risk of duplicative over-taxation and threatened revenue collections of states that fully comply with constitutional nexus requirements.

BATSA would prevent unlawful impediments to the free flow of commerce among the states by clarifying that no state may impose a business activity tax on any entity that lacks a physical presence in the taxing jurisdiction. The bill would provide a bright-line definition of physical presence. In addition, the Act would modernize current law (Pub. L. 86-272) relating to state authority to impose net income taxes on certain income derived from interstate commerce, to cover services and intangible property. Finally, BATSA would ensure that each corporation that is a member of a combined group of corporations is itself treated as a separate person, and the economic activity of a corporation cannot be included in a combined return unless the corporation itself has a physical presence in the state. Thus, businesses would continue to pay business activity taxes to those jurisdictions that provide them with meaningful benefits and protections.

Enactment of BATSA would contribute to the type of stable business climate that encourages increased business investment, expanded interstate commerce and a healthy American economy. To be clear, our company does not seek to pay less tax in states where we have a physical presence; we simply desire clarity and consistency as we serve customers on a multi-state basis.

For Regulator Marine, this legislation is vitally important because it will help ensure fairness and predictability by clarifying a bright-line nexus standard that may be predictably understood and applied. Smaller companies like ours typically cannot afford to litigate an unfair tax assessment made by a state where we have no physical presence. Therefore, enactment of BATSA is the only way to ensure that overreaching by the states does not destroy our business.

Thank you for your time and attention, and please let me know if I can be of any assistance to you on this important matter.

Sincerely,

Joan Maxwell/mb.

Joan Maxwell
Regulator Marine, Inc.
cc: file

Statement of the Securities Industry and Financial Markets Association
Submitted to the House Judiciary Subcommittee on
Commercial and Administrative Law
April 13, 2011

H.R. 1439, the Business Activity Tax Simplification Act

The Securities Industry and Financial Markets Association[1] supports H.R. 1439 the *Business Activity Tax Simplification Act of 2011* (BATSA). This important legislation would provide necessary clarity regarding the application of state or local government business activity taxes to companies that do not have a physical presence in the taxing jurisdiction. The bill would provide this clarity by establishing bright lines specifying the amount of physical presence in the jurisdiction needed to trigger tax liability.

In 1992, the U.S. Supreme Court ruled in *Quill Corp. v. North Dakota* that a state could not require an out-of-state business to collect sales and use tax unless that business has a "substantial nexus" within the taxing state. At that time, the Supreme Court declined to explicitly rule on the nexus standard as applied to business activity taxes. Many tax experts inferred that the same standard logically should be applied in the case of the direct imposition of business activity taxes. Unfortunately, over time, state and local governments have increasingly sought to define "substantial nexus" much more expansively, leading to costly litigation and uncertainty for both business taxpayers and state and local governments.

More recently, the U.S. Supreme Court refused to review two lower court cases that challenged the constitutionality of state efforts to tax out-of-state companies based on "economic presence" rather than "physical presence." Refusal to review these cases has added to the existing uncertainty and increased the need for Congressional action to clarify when a state can tax a business with little or no physical presence in the state.

BATSA removes confusion and the potential for double taxation inherent in the absence of clear rules specifying when state or local governments can impose business activity taxes. This is particularly important to the financial services industry because some jurisdictions seek to impose business activity taxes on companies that have no physical presence in the state but that increasingly serve customers remotely through mail and the internet.

By establishing clear and consistent bright-line standards, H.R. 1439 will provide certainty in interstate commerce to both businesses and to state and local governments. SIFMA urges Congress to act on this important legislation.

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[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

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Testimony
by
Vernon T. Turner

Vice President, Corporate Tax
Smithfield Foods, Inc.
200 Commerce Street
Smithfield, Virginia 23430

On the Issue of State Jurisdiction to Tax Business Activity

Before the United States House of Representatives

Committee on the Judiciary

Subcommittee on Courts, Commercial and Administrative Law

The Honorable Howard Coble, Chairman

April 13, 2011

Mr. Chairman and members of the subcommittee,

On behalf of Smithfield Foods, Inc, I respectfully submit the below testimony for the record. My name is Tracy Turner, and I am Vice President, Corporate Tax for Smithfield Foods, Inc. I last testified before the Committee on the Judiciary, Subcommittee on Courts, Commercial and Administrative Law, in 2004. In my testimony, I stated that current state interpretation of the business activity tax was doing a substantial amount of damage to the American business community and to companies like Smithfield Foods. Since that time, the state tax landscape has gotten significantly more complex, and the various state tax authorities are far more aggressive. It is our hope that the House Business Activity Tax Simplification Act of 2011 can ameliorate this situation.

I. Introduction

- Background on Smithfield Foods

Smithfield Foods, Inc. is the world's largest pork processor and hog producer, headquartered in Smithfield, Virginia. We have worldwide sales of over $11 billion, and are a "Fortune 200" company. Our company has experienced remarkable growth from its early origins as a small pork processor. Today, we are a worldwide company, with sales in all fifty states. Our various subsidiaries have physical operations in twenty states.

- Why Smithfield is Testifying

We incur substantial costs to meet our state tax obligations. On an annual basis, we are

required to file 1,100 state income tax returns, 400 sales and use tax returns, 2,600 state payroll tax returns and 1,100 real and personal property tax returns. This results in various state payments of approximately $105 million. In spite of our efforts to comply with laws with all the states, we continue to find state interpretation of the business activity tax to be difficult and troublesome.

II. The Problem — Bureaucratic Arbitrariness

The U.S. Supreme Court and Congress have decided that states may not unduly burden companies that have no physical presence in a state with "business activity taxes."

In 1992, the U.S. Supreme Court held in Quill Corporation v. North Dakota that the U.S. Constitution requires a bright line physical presence rule for the imposition of use tax collection responsibility. Many scholars and state tax experts believe that the Quill standard applies to all state taxes, not just use tax.

Public Law 86-272, still good law, was enacted by the U.S. Congress to provide a similar bright line standard. It bars states from imposing a net income tax on companies whose only in-state activity is the solicitation of sales of tangible personal property.

Despite the decision of the U.S. Supreme Court and Congress, states continue to attempt to tax companies regardless of physical presence. States have, for example, enacted and imposed gross receipts taxes, net worth taxes and fixed dollar minimum taxes on out of state companies under the theory that Public Law 86-272 bars imposition of only net income tax. States have argued too, that Quill applies only to use tax. As a result, businesses struggle with multistate tax compliance in the face of conflicting and confusing guidance. This situation needs to be clarified, and BATSA seeks to do that and not more.

III. BATSA

Interstate sales are today more the rule than the exception, not only for large corporations like Smithfield, but small and medium sized enterprises as well. The current state of confusing and arbitrary taxation of multi-state companies that are selling product across state lines only serves to chill interstate commerce. BATSA will eliminate confusion and the need for companies to engage in protracted and costly litigation as the way of ameliorating discrepancies in tax enforcement. BATSA does not diminish the ability of states to collect tax revenue. It rationalizes and makes more predictable the process of doing so.

IV. A Smithfield Experience with State Tax Law

We experienced a prime example of the arbitrary and confusing application of state income tax laws. This example is not a gross exception. In fact, it is just a metaphor of a larger problem. A collection agent with the New Jersey Department of Taxation stopped one of our trucks, loaded with refrigerated product, on the New Jersey turnpike. The

agent held the truck and its driver for several hours, and demanded that, in order to release the truck, Smithfield had to wire $150,000 immediately to the New Jersey Department of Taxation. The agent claimed that he had the right to hold the truck and its contents because we had failed to properly file New Jersey tax returns.

I informed the Jersey agent that his claim was unfounded. I explained that Public Law 86-272 protected our subsidiary from New Jersey income taxation since it only engaged in mere solicitation in New Jersey and had no physical operations in the State. The agent refused to accept this explanation. However, he finally agreed to release the truck and its driver in return for $8,000.

We appealed this aggressive and incorrect application of Public Law 86-272 to the New Jersey State tax commissioner. Ultimately, New Jersey accepted our contention that we have no physical presence in the State and are not subject to New Jersey income tax. They issued a refund and an apology for their roadside justice system.

Our experience is not unique; it is shared by many businesses, large and small. Many small companies do not have the ability to make an immediate wire transfer of funds much less obtain ultimate recourse from aggressive states. We believe that BATSA will clarify the physical presence standard embodied in Public Law 86-272 and the Quill decision. This is sound public policy and we urge its passage.

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 H.R 1439:

"THE BUSIENSS ACTIVITY TAX SIMPLIFICATION ACT OF 2011"

APRIL 13, 2011

STATEMENT FOR THE RECORD OF

SOFTWARE FINANCE & TAX EXECUTIVES COUNCIL

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 H.R. 1439, "The Business Activity Tax Simplification Act of 2011." 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 H.R. 1439 and urges the Subcommittee to take quick action on the bill and report it to the full committee.

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*, 2010 NY Slip Op 07823 (81 AD3d 183) (Nov. 4, 2010).

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 well-established international tax norms.

The Subcommittee will hear testimony on behalf of state tax administrators to the effect that the physical presence standard is inappropriate in light of modern electronic commerce business models that enable firms to penetrate and exploit a state's market without ever establishing any sort of physical presence in the state. Indeed, electronic commerce is

borderless. However, while electronic commerce may be borderless, states do have borders and the physical presence nexus standard ensures that states respect them and prevents states from reaching into their neighbors and taxing nonresident businesses.

Nonresident businesses play no role in the political life of states where they have no property or employees. State tax administrators advocate an economic nexus standard, which is no standard at all, so they can export their states' tax burdens to people outside their state. Businesses having no property or employees in a state place no burdens on a state's resources. One of the cornerstones of the Supreme Court's interstate tax jurisprudence is that in order for a tax to be sustained against a Commerce Clause challenge, the tax must be "fairly related to the services provided by the state." See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Any claim that a nonresident business consumes "services provided by the state" is speculative at best.

To give an example of the complexity an economic nexus standard could visit on a software vendor, imagine a developer of smartphone apps that the vendor sells for $1.00 per download. The app is downloaded to thousands of customers in every state and locality in the United States. An economic nexus standard would expose such a vendor to reporting, payment and audit liability in every state, county, city and special assessment districts, like transit districts, water drainage districts and mosquito abatement districts, in the country. In light of this compliance burden, there is not enough money in the app to make its development worthwhile.

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.
>
> *Quill, supra,* 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 19 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 supplied 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 many states have since imposed in order to circumvent P.L. 86-272's protections.

States are becoming increasingly 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 and clarify when out-of-state taxpayers have a tax obligation to another state. The legislation on which the Subcommittee is holding this hearing, "The Business Activity Tax Simplification Act of 2011, H.R. 1439 ("BATSA"), 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. 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. In addition, the bill would put a stop to states' attempts to circumvent the existing physical presence standard through technical changes to their apportionment formulae applicable to affiliated persons, which have the effect to subjecting to tax business activity taking place in other states.

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.

TAXATION SECTION
THE STATE BAR OF CALIFORNIA

April 12, 2011

VIA HAND DELIVERY

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

Re: State Tax Nexus White Paper

Dear Congressional Members and Congressional Committee Members:

Enclosed please find a white paper addressing *The Modernization of P.L. 86-272: State Tax Nexus Fifty Years Later*. This white paper was prepared, submitted and presented to various congressional groups in May 2010 as part of the California State Bar Taxation Section's annual Washington DC Delegation.

Any questions regarding the white paper should be directed to its author, Tim Gustafson, or to me. Mr. Gustafson can be reached at (916) 325-1312 and I can be reached at (916) 325-1316.

Very truly yours,

Carley Roberts

Carley A. Roberts
Chair, Taxation Section
The State Bar of California

Enclosure

231636 1

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STATE BAR OF CALIFORNIA
TAXATION SECTION

THE MODERNIZATION OF P.L. 86-272: STATE TAX NEXUS FIFTY YEARS LATER

This proposal was principally prepared by Tim Gustafson, a member of the Taxation Section of the California State Bar.[1] The author wishes to thank Carley Roberts of Morrison & Foerster LLP for her contributions. The author also wishes to thank the reviewers, Arthur Rosen of McDermott Will & Emery LLP and Kimberley Reeder of Morgan Lewis & Backius LLP, for their valuable insights and comments.[2]

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[1] The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association. A number of members of the State Bar of California Taxation Section, including members of the State's taxing agencies, specifically disagree with the position taken herein.

[2] Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate in this project.

EXECUTIVE SUMMARY[3]

Over fifty years ago, Congress enacted Public Law 86-272 in response to a United States Supreme Court decision regarding a state's ability to tax purely interstate activities. 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. Despite the stated intention of Congress that Public Law 86-272 was to be a temporary solution and the undeniable shift in the focus of the economy from goods to services and intangibles since 1959, Public Law 86-272 remains on the books, a seemingly permanent fixture in the ever-changing landscape of state taxation.

Recently, a growing trend by the states to impose taxes on out-of-state corporations based on a theory of "economic nexus," a standard for determining taxable presence in a particular state based on a corporation's economic relationship to persons in that state, has resulted in widespread litigation. Corporate taxpayers and state taxing authorities are at odds over whether such taxes properly reflect appreciable benefits received by a corporation from the taxing jurisdiction. Notably, the United States Supreme Court has remained silent on the issue.

The Business Activity Tax Simplification Act of 2009 would modernize current law and provide definitive standards to govern when states may impose certain taxes on purely interstate activities. By modernizing the law to cover recently-invented taxes such as single business taxes, commercial activity taxes, and margin taxes, as well as other taxes imposed directly on a business such as gross receipts taxes, franchise taxes, capital stock taxes, and business and occupation taxes, and by imposing a

[3] Tim Gustafson is an associate with Morrison & Foerster LLP. The views expressed herein are those of the author and do not necessarily reflect the views of Morrison & Foerster LLP. The information contained herein is general in nature and is not intended, and should not be construed, as legal, accounting, or tax advice or an opinion provided by Morrison & Foerster LLP to the reader. The reader also is cautioned that this material may not be applicable to, or suitable for, the reader's specific circumstances or needs, and may require consideration of non-tax and other factors if any action is to be contemplated. The reader should contact his or her tax advisor prior to taking any action based upon this information. Morrison & Foerster LLP assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect the information contained herein.

bright-line physical presence standard whereby such taxes could only be on those businesses that have a physical presence (employees, agents, or taxable property) within the taxing jurisdiction, the proposed legislation would minimize litigation to a large extent and ensure fairness in today's economy. Valuable resources would be saved by both state governments and the business community; moreover, a chilling effect on commerce would be removed.

DISCUSSION

I. BACKGROUND

"Unless immediate action is taken at this time, it is feared that the States will amend their laws to further encroach upon interstate commerce."[4]

So spoke Senator Byrd of Virginia on August 11, 1959, in response to the United States Supreme Court's opinion in *Northwestern Cement v. Minnesota*[5] and on behalf of Public Law 86-272 ("P.L. 86-272"). Over fifty years later, the disquieting significance of Senator Byrd's plea is more pertinent than ever. While prohibiting a state from imposing an income tax upon a corporation whose only activity carried on within the state is "solicitation" of orders for the sale of tangible personal property, P.L. 86-272 to many taxpayers is an anachronism, a static solution for a dynamic problem that needs to be revisited. The Business Activity Tax Simplification Act of 2009 ("BATSA 2009")[6] modernizes P.L. 86-272 and responds to continuing concerns in an effective and contemporary manner.

A. P.L. 86-272

1. *The Impetus:* Northwestern Cement v. Minnesota

In 1959, the U.S. Supreme Court upheld a state's power to tax income generated from purely interstate activities in *Northwestern Cement v. Minnesota*.[7] *Northwestern Cement* arose when two state supreme courts, considering similar factual scenarios, arrived at diametrically opposed conclusions regarding whether a state statute may properly tax income generated from activities exclusively in furtherance of interstate commerce.[8] In each case, a company had within the taxing state a permanent office and one or more salesmen who actively solicited within the state orders for the purchase of the company's products. However, all orders were accepted at, and filled from, the company's head office in another state. The Supreme Court of Minnesota had upheld the validity of a state statute

[4] Sen. Byrd (VA), Cong. Rec. (Aug. 19, 1959) at 16354.
[5] 358 U.S. 450 (1959).
[6] H.R. 1083 (2009).
[7] 358 U.S. 450 (1959).
[8] *State v. Northwestern States Portland Cement Co.*, 250 Minn. 32 (1957); *Stockholm Valves & Fittings, Inc. v. Williams*, 213 Ga. 713 (1957).

taxing such transactions.[9] The Supreme Court of Georgia, on the other hand, had held that a similar statute, as applied, violated both the Due Process Clause and the Commerce Clause of the Federal Constitution.[10] Making a determination that the net income derived from the operations of the companies within the taxing states provided a sufficient nexus with Minnesota and Georgia for taxing purposes, the U.S. Supreme Court affirmed the former, reversed the latter and held that such state taxes violate neither the Commerce Clause nor the Due Process Clause of the Federal Constitution.

Specifically, the Court found such a tax to be valid if it does not discriminate against interstate commerce and is properly apportioned to the taxpayer's activities within the state that create nexus. Moreover, the Court held that such a tax was within the Due Process clause of the U.S. Constitution because fair apportionment led to only taxing income arising in the taxing state. The Court referred to its earlier decision, *Wisconsin v. J.C. Penney Company*,[11] stating, "the 'controlling question is whether the state has given anything for which it can ask return.' Since by 'the practical operation of [the] tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred . . . .' it 'is free to pursue its own fiscal policies, unembarrassed by the Constitution.'"[12]

2. *The Response: The P.L. 86-272 "Stopgap"*

The "broad language"[13] found in the *Northwestern Cement* decision raised many concerns for businesses and Congress.[14] Of particular concern for businesses was how to determine the type of activities in a state that would give rise to sufficient nexus so as to subject a business to income tax there. If such determination could be made, the question

[9] 250 Minn. at 44.
[10] 213 Ga. at 721.
[11] 311 U.S. 435, 444 (1940).
[12] *Northwestern Cement*, 358 U.S. at 465. Prior to that time, there had been a "well-settled rule, stated in *Norton Co. v. Illinois Dep't of Revenue*, 340 U.S. 534 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place." (*Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).)
[13] SEN. RPT. NO. 658 (Aug. 11, 1959) to S. 2524.
[14] As did the Court's refusal to hear *Brown-Forman Distillers Corp. v. Collector of Revenue*, 234 La. 651 (1958), *appeal dism'd and cert. denied*, 359 U.S. 28 (1959), a case which found that the imposition of the Louisiana net income tax upon a Kentucky distiller did not hinder interstate commerce, despite the fact that the distiller's only activity in Louisiana was the presence of "missionary men" who called on wholesalers but did not solicit orders.

remained of how to fairly apportion income of a multistate business among states in which it had nexus under *Northwestern Cement*. Moreover, the Court's latitudinous language allowed for non-uniform rules among the states, the costs of compliance with which might even exceed the tax owed in some cases, and the practical effect of which might cause income from a single sale to be attributed to more than one state.

Of concern for Congress was that such uncertainty and the burden of compliance that inevitably followed could lead some businesses, particularly small businesses, to limit their interstate activities.[15] There was even concern that states would use *Northwestern Cement* to assess taxes for past years.[16]

Congress responded swiftly. Just seven months after *Northwestern Cement* was decided, P.L. 86-272 was enacted. The intended goal was a more certain rule for when a multistate business would be subject to income tax in any particular state. The articulated rule prohibited a state from imposing a net income tax (direct or indirect) upon a taxpayer if that taxpayer's only in-state activity is "solicitation" of orders for the sale of tangible personal property, where the orders are sent outside the state for approval or rejection and, if approved, are filled and delivered from a stock of goods located outside the state.

The Senate Report noted that the legislation was "not a permanent solution to the problem."[17] Rather, the legislation was intended to "serve as an effective stopgap or temporary solution while further studies are made of the problem,"[18] despite the absence of a termination date.[19]

B. Application of P.L. 86-272

Shortly after its passage, state courts wrestled with the new legislation. In *International Shoe Co. v. Cocreham*,[20] the Louisiana Supreme Court revisited its pre-P.L. 86-272 decision in *International Shoe Company v. Fontenot*,[21] in which it had found under an identical set of facts

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[15] *See* Annette Neilen, "The 50th Anniversary of Public Law 86-272" (March 27, 2008).
[16] *See id.*
[17] SENATE RPT. NO. 658 (Aug. 11, 1959).
[18] *Id.*
[19] CONG. REC. (Aug. 19, 1959) at 16357.
[20] 246 La. 244 (La. 1964).
[21] 236 La. 279 (La. 1959), *cert. denied* 359 U.S. 984 (1959).

that the company was liable for state taxes upon its net income arising from its operations in Louisiana. The court in *International Shoe Co. v. Cocreham*, however, held that the activities of the company carried on within the state[22] were now protected by P.L. 86-272, and thus, the company was not taxable in the State of Louisiana. In effect, the second *International Shoe* decision deemed P.L. 86-272 a valid enactment by Congress.

Similarly, the Supreme Court of Missouri applied the protections afforded by P.L. 86-272 to a foreign corporation in *CIBA Pharmaceutical Products, Inc. v. State Tax Commission.*[23] The court held that the State of Missouri may not burden interstate commerce and tax a foreign corporation whose only activities (solicitation of orders) were protected under the new federal law.

Despite the state court decisions suggesting that P.L. 86-272 was a constitutionally valid exercise of Congress' power to regulate interstate commerce, the legislation and its proposed progeny were not without their critics. A study[24] completed in 1964 by the House Committee on the Judiciary Special Subcommittee on State Taxation of Interstate Commerce addressed the inherent tension between "protecting businesses from uncertainty and multiple taxation and preserving state tax authority and revenues."[25] The study, which concluded that, among other things, businesses should not be subject to direct taxes where business merely have customers but no physical presence,[26] resulted in a series of proposed yet ultimately unsuccessful bills,[27] the revisions of which reflected the competing interests of the business community at large and the state taxing authorities.

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[22] The company's only business activities carried on within the State of Louisiana were the use of travelling salesmen in the state for the "solicitation" of orders for shoes that were forwarded to the company's home office in St. Louis, Missouri, and then, if accepted, were filled and the merchandise shipped from outside the State of Louisiana. 246 La. at 251)

[23] 382 S.W.2d 645 (Mo. 1964).

[24] P.L. 86-272 directed Congress to ". . . make full and complete studies of all matters pertaining to the taxation by the States of income . . . from the conduct of business activities which are exclusively in furtherance of interstate commerce . . . for the purpose of recommending to the Congress proposed legislation providing uniform standards to be observed by the states in imposing income taxes on income so derived."

[25] Annette Nellen, "The 50th Anniversary of Public Law 86-272" (March 27, 2008). The study is known as the Willis Commission report.

[26] 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).

[27] *See, e.g.*, H.R. 11798 (1965); H.R. 16491 (1966); H.R. 2158 (1967).

The language of P.L. 86-272 limits its scope. The law applies only to income taxes, not to other business taxes such as gross receipts taxes.[28] The law applies only to sales of tangible personal property, not to sales of services or intangibles. Thus, companies engaged exclusively in interstate commerce (albeit of a different type) found themselves and continue to find themselves subject to state taxation.

With the "temporary" solution in place, constitutional nexus issues affecting all corporations not protected by P.L. 86-272 were battled out in the state courts, with the U.S. Supreme Court intervening from time to time to offer a modicum of clarity. Shortly after the passage of P.L. 86-272, the U.S. Supreme Court issued its decision in *Scripto Inc. v. Carson*,[29] articulating principles of attributional, or agency, nexus and leaving no doubt that activities performed in a state on behalf of a taxpayer may establish nexus to tax.[30] In the seminal case of *National Bellas Hess, Inc. v. Department of Revenue*,[31] the U.S. Supreme Court held that a state imposes an unconstitutional burden on interstate commerce when it attempts to force tax collection or remittance responsibilities on an out-of-state entity that lacks any "physical presence in the taxing State."[32] In 1977, the Court in *Complete Auto Transit, Inc. v. Brady*,[33] a decision that applies equally to income, franchise or transaction taxes, established a four-part test to determine whether a state tax imposed on transactions in interstate commerce violates the Commerce Clause.[34] The Court decided, in relevant

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[28] The protections of P.L. 86-272 do not apply where a state's corporate tax includes a non-income component. *See Bantam Doubleday Dell Publishing v. Dep't of Treasury*, No. 243672 (Feb. 24, 2004) (holding P.L. 86-272 does not apply to the single business tax).

[29] 362 U.S. 207 (1960).

[30] Following *Scripto*, state tax agencies and state courts found attributional nexus where the activities of an in-state representative or affiliate were attributable to an out-of-state company. *See, e.g., In re Dart Indus., Inc.*, N.M. Taxn. and Rev. Dep't., No. 04-03, 2/26/04; *Western Acceptance Co. v. Dep't of Revenue*, 572 So.2d 497 (Fl. 1985); *Avco Consumer Servs. Consumer Discount Co. One, Inc. v. Director, Div. of Taxation*, 100 N.J. 27 (N.J. 1985). Over 25 years after its decision in *Scripto*, the U.S. Supreme Court's decision in *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987) affirmed the agency principles established in *Scripto* and agreed with the Washington Supreme Court that "'the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.'" 483 U.S. at 250 (internal citation omitted). As discussed below, BATSA 2009 adopts similar language in providing for attributional nexus.

[31] 386 U.S. 753 (1967).

[32] *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

[33] 430 U.S. 274 (1977).

[34] Under *Complete Auto*, a state tax does not violate the Commerce Clause of the Federal Constitution where the tax (1) is 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.

part, that in the absence of congressional action, the Commerce Clause permits taxation of out-of-state businesses only where, *inter alia*, the tax "is applied to an activity with a substantial nexus with the taxing State."[35] And in 1992, the Court in *Quill Corp. v. North Dakota*[36] applied this test in the context of sales and use taxes and reaffirmed *Bellas Hess*, holding that a taxpayer, in addition to the activity, must have a "substantial nexus" with the state for purposes of state taxes and that for sales and use taxes, such a standard could be met only where the corporation has a "physical presence" in the taxing state.[37]

Even P.L. 86-272 required some clarification. P.L. 86-272 does not define the term "solicitation." After state court decisions interpreted the term in inconsistent ways, from very broad to very restrictive, the U.S. Supreme Court weighed in. In *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*,[38] the Court defined the term "solicitation of orders" to include "not just explicit verbal requests for orders, but also any speech or conduct that implicitly invites an order" and afforded immunity to activities that are "entirely ancillary to requests for purchases."[39] The Court also ruled that a *de minimis* rule applied to activities that may exceed solicitation, not wanting to abandon the principle in the context of a law such as P.L. 86-272, "which operates in such stark, all-or-nothing fashion."[40] The Court's guidance in *Wrigley* notwithstanding, state courts and revenue departments continued to examine whether certain taxpayer activities qualify for protection under P.L. 86-272.

II. PRESENT DAY STATE APPROACHES TO TAXATION OF INTERSTATE ACTIVITIES

The American economy has changed dramatically since the enactment of P.L. 86-272 in 1959. There has been a clear shift in the focus of the economy from manufacturing and selling tangible personal property to producing and selling services and intangibles, income from which is not

[35] 430 U.S. at 279.
[36] 504 U.S. 298 (1992).
[37] *Id.* at 314. The Court in *Quill* demarcated the purpose of the Commerce Clause nexus analysis, to "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce," from that of the Due Process nexus analysis, which was based on "the fundamental fairness of governmental activity." 504 U.S. at 312 – 313.
[38] 505 U.S. 214 (1992).
[39] *Id.* at 223, 228.
[40] *Id.* at 231.

protected under P.L. 86-272. Also, some states have enacted business taxes that are not income taxes and instead look to gross receipts as their tax base (and, as such, are more akin to sales and use taxes). When a business is not covered by the "protection" of P.L. 86-272, Due Process and Commerce Clause guidance governs whether a state may tax the income of a multistate business. Most states have provided nexus guidance either legislatively or administratively, but as was the situation decades ago, such guidance is far from uniform among the states.

A. Legislative Potpourri (Economic Nexus Legislation)

Whereas the U.S. Supreme Court has spoken on nexus in the past, to date it has kept mum regarding the rapidly evolving issue of economic nexus.[41] Many states have heard the U.S. Supreme Court's silence loud and clear. Energized by the growing trend toward economic nexus, a number of states have recently flexed their constitutional muscles through the enactment of legislation to determine what activity of a business in that state makes that business subject to tax therein.

New Hampshire, for example, adopted an economic nexus standard for purposes of its business profits tax, amending the statutory definition of business activity to include "a substantial economic presence evidenced by a purposeful direction of business toward the state."[42] In considering the underlying legislation, the New Hampshire Senate had deferred consideration of this particular provision while the economic nexus question was pending before the U.S. Supreme Court.[43] On the day the

[41] *See, e.g.*, *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *Capital One Bank v. Comm'r of Revenue*, 453 Mass. 1 (Mass. 2009), *cert. denied*, 129 S. Ct. 2827 (2009); *A & F Trademark, Inc. v. Tolson*, 167 N.C. App. 150 (N.C. Ct. App. 2004), *cert. denied*, 359 N.C. 320, *cert. denied*, 546 U.S. 821 (2005); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); *Tax Comm'r v. MBNA Am. Bank, N.A.*, 220 W. Va. 163 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007).

[42] N.H. REV. STAT. ANN. § 77-A:1.XII. Along these same lines, the Oregon Department of Revenue adopted Administrative Rule 150-317.010, which states, "[s]ubstantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state." The rule looks to the regularity of contacts in the state, deliberate marketing to or solicitation of Oregon customers, and gross receipts attributable to Oregon customers or to the use of intangible property in the state.

[43] *See Lanco, supra*, and *MBNA, supra*.

Court denied certiorari, the legislation was amended and the economic nexus provision enacted.[44]

In California, "doing business" will be defined in accordance with the Multistate Tax Commission's proposed "factor presence" nexus test for tax years beginning on or after January 1, 2011.[45] Thus, a taxpayer will be considered to be doing business in California, and therefore subject to California's corporation franchise tax, if it meets any of the following conditions: (1) the taxpayer is organized or commercially domiciled in California; (2) the taxpayer's sales in California exceed the lesser of $500,000 or 25% of the taxpayer's total sales; (3) the value of the taxpayer's real and tangible personal property in California exceeds the lesser of $50,000 or 25% of the taxpayer's total real and tangible personal property; or (4) the taxpayer pays compensation in California exceeding the lesser of $50,000 or 25% of the total compensation paid by the taxpayer.[46]

Connecticut also recently adopted an economic nexus standard for corporate income taxation effective for tax years beginning after 2009.[47] Specifically, "[a]ny company that derives income from sources within this state, or that *has a substantial economic presence within this state*, evidenced by a purposeful direction of business toward this state, examined in light of the frequency, quantity and systematic nature of a company's economic contacts with this state, *without regard to physical presence*, and to the extent permitted by the Constitution of the United States, shall be liable for the tax imposed under chapter 208 of the general statutes."[48]

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[44] *See* Chris Sullivan, *News Analysis: New Hampshire Adopts Economic Nexus Standard*, STATE TAX TODAY, 2007 STT 137-13 (July 17, 2007).

[45] *See Factor Presence Nexus Standard for Business Activity Taxes*, Multistate Tax Commission (approved Oct. 17, 2002; updated Sept. 2003). According to the proposal summary, the "factor presence nexus standard is intended to represent a simple, certain and equitable standard for the collection of state *business activity taxes*" (emphasis added). Ironically, the proposal summary attributes the "idea of factor presence nexus" and the elaboration of the concept to an article in the December 2000 edition of *National Tax Journal* entitled, "Implementing State *Corporate Income Taxes* in the Digital Age" (emphasis added).

[46] CAL. REV. & TAX. CODE § 23101 (2009). The threshold amounts used in this test will be adjusted annually for inflation. Similarly, the State of Colorado has recently proposed an amendment to its tax regulations allowing for the Multistate Tax Commission's factor presence nexus model. *See* Proposed Regulations 39-22-301.1, 1 CCR 201-2.

[47] Public Act No. 09-3, Sec. 90, 2009 Ct. ALS 3. *Cf.* Regs. Conn. St. Agencies § 12-214-1.

[48] *Id.*, (emphasis added).

B. Judicial Potpourri (Economic Nexus Decisions)

State courts have validated this legislative approach. Starting in the early 1990s and proliferating in recent years, some states have attempted to expand their tax base by assessing business activity taxes (i.e., non-income taxes) against out-of-state companies that have customers or intangibles but no property or employees in the taxing state. Under these circumstances P.L. 86–272 does not apply. As a defense in these cases, many businesses have argued that the physical presence nexus standard established by the U.S. Supreme Court in *Quill* must apply.

Several court decisions, which recognized that the U.S. Supreme Court's decision in *Quill* necessitated addressing the issue of "substantial nexus," have nevertheless ruled that the physical presence standard established by *Quill* is only relevant for sales and use tax nexus and does not apply with regard to other types of taxes.[49] In these cases, the courts have held that the existence of "economic presence" is enough to create nexus for purposes of the Commerce Clause. Conflicting holdings exist in several jurisdictions and the U.S. Supreme Court has yet to grant review.

For example, in *J.C. Penney National Bank v. Johnson*, the Tennessee Supreme Court upheld on its merits a decision that state taxing authorities could not impose upon out-of-state corporations with no in-state physical presence excise and franchise taxes on corporate earnings or profits.[50] The Tennessee Court of Appeals held that no valid distinction can be drawn for Commerce Clause purposes between excise and franchise taxes and the sales and use taxes at issue in *Bellas Hess* and *Quill*:

> The only real issue is whether there is any reason to distinguish the present case from Bellas Hess and Quill. The Commissioner argues that those cases are distinguishable because they involved use taxes, whereas the present case involves franchise and excise taxes. We must reject the Commissioner's argument. While it is true that the Bellas Hess and Quill decisions focused on use taxes, we find no basis for concluding that the

[49] *See, e.g.*, *Geoffrey, Inc. v. S.C. Tax Comm'n*, *supra*.
[50] 19 S.W.3d 831, 838-39 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

> analysis should be different in the present case. In fact, the Commissioner is unable to provide any authority as to why the analysis should be different for franchise and excise taxes.[51]

The Tennessee Supreme Court issued an Order denying review and allowing the Court of Appeals decision to be published.[52] Under Tennessee law, denial of review by the Tennessee Supreme Court – unlike denial of certiorari by the U.S. Supreme Court – establishes agreement with the result below. The U.S. Supreme Court subsequently denied review.

In contrast, and most recently, the Washington Court of Appeals ruled that a taxpayer without physical presence in the State of Washington was nevertheless found to have "substantial nexus" with the state for business and occupation tax purposes where the activities of the taxpayer's employees were significantly associated with the taxpayer's ability to establish and maintain its market there.[53] The taxpayer, an out-of-state manufacturer, unsuccessfully argued that physical presence was required to show substantial nexus under *Quill*.[54] The court disagreed, concluding that the language in *Quill* was limited to cases involving sales and use taxes and thus not applicable to an excise tax levied for the privilege of doing business within the state.[55] The court found that the taxpayer's in-person customer visits, albeit infrequent, were necessary to maintain its in-state customer base, particularly in light of the taxpayer's business strategy of maintaining long-term relationships with a small number of customers.[56]

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[51] 19 S.W. 3d at 839.

[52] See *J.C. Penney National Bank v. Johnson, Comm'r of Revenue*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000) (per curiam). By allowing the Court of Appeals opinion to be published, the Tennessee Supreme Court gave it precedential effect. As the Tennessee Supreme Court has explained, "the published opinions of the intermediate appellate courts are opinions which have precedential value and may be relied upon by the bench and bar of this state as representing the present state of the law with the same confidence and reliability as the published opinions of this Court, so long as either are not overruled or modified by subsequent decisions." *Meadows v. State*, 849 S.W. 2d 748, 752 (Tenn. 1992). Thus, it is settled law in Tennessee that taxes upon income are subject to the *Bellas Hess/Quill* physical-presence rule.

[53] *Lamtec Corp. v. Washington Dep't of Revenue*, 151 Wn. App. 451, 466 (2009), *pet. for rev. granted*, 2010 Wash. LEXIS 157 (2010). The Supreme Court of Washington granted the taxpayer's petition for review on February 11, 2010.

[54] *Id.* at 463.

[55] *Id.* at 463-464.

[56] *Id.* at 465.

II. BATSA 2009

A. The Legislation

BATSA 2009 would establish a bright-line "physical presence" standard for the imposition of state and local "business activity taxes." In codifying this standard, no state would have the power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person's activities in interstate commerce unless the person has a physical presence in the taxing state during the relevant taxable period. Carve-outs to the physical presence standard include a *de minimis* physical presence exception (i.e., presence in a state for less than 15 days in a taxable year)[57] and presence in a state to "conduct limited or transient business activity."[58]

BATSA 2009 would also modernize P.L. 86-272[59] so it would apply to all "business activity taxes," which are defined as "any tax in the nature of a net income tax or measured by the amount of, or economic results of, business or related activity conducted in the State." Notably, transaction taxes, such as sales and use taxes, are excluded from this definition.[60] P.L. 86-272's limitation to solicitation of "sales" of "tangible personal property" would be removed and the law would apply to the solicitation of orders (which are sent outside the state for approval or rejection) or of "customers ... for sales or transactions." The bill would also amend P.L. 86-272 to protect certain other "business activities" from the imposition of state "business activity taxes," including "the furnishing of information to customers or affiliates" in the state; the "coverage of events or other gathering of information" in the state, "which information is used or disseminated from a point outside the State"; and "business activities directly related to [the taxpayer's] potential or actual purchase of goods or services within the State if the final destination to purchase is made outside the State."

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[57] Prior versions of this legislation mandated a 21-day threshold.

[58] The legislation does not define "limited" or "transient" for purposes of this exclusion.

[59] According to the terms of the legislation, nothing in the section of the bill relating to the physical presence standard shall be "construed to modify, affect or supersede the operation" of P.L. 86-272.

[60] Remote vendor sales tax collection has become a subject of heightened interest to the states, businesses, and Congress, and has led to some talk of a federal legislative solution. For a general discussion of this issue, *see* Robert D. Plattner, Daniel Smirlock, & Mary Ellen Ladouceur, *A New Way Forward for Remote Vendor Sales Tax Collection*, STATE TAX NOTES, Vol. 55, No. 3 (Jan. 18, 2010).

B. The Business Perspective

Many businesses believe that they should continue to pay business activity taxes in those states where they receive direct benefits and protections, such as police, fire, sanitation, public schools, etc., from the state government, i.e., where they have substantial nexus with the taxing state in the form of physical presence as constitutionally sanctioned by the U.S. Supreme Court in *Bellas Hess* and *Quill*. Many businesses thus support federal legislation, such as H.R. 1083, BATSA 2009, which would modernize current law and provide definite, specific standards to govern when states may impose a business activity tax. BATSA 2009's nexus standard would, from the business perspective:

- ensure fairness;
- minimize litigation;
- create the kind of legally certain and stable business climate that encourages businesses to make business investments, expand interstate commerce, grow the economy, and create new jobs; and
- ensure a level playing field for taxpayers by using a bright-line standard analogous to the permanent establishment standard used by the United States in international treaties.[61]

Moreover, the legislation would modernize current law and establish a clear and equitable bright line standard. Specifically:

The legislation would modernize P.L. 86-272 by amending the law to apply to all sales and transactions, not just sales of tangible personal property and to all business activity taxes, not just net income taxes.

The legislation would establish a physical presence nexus standard, whereby states and localities would be authorized to impose direct business activity taxes only on those businesses that have a physical presence (employees, agents, or property) within the taxing jurisdiction.

[61] BATSA 2009 establishes a threshold that is even lower than that set by the "permanent establishment" standard used by the federal government in international tax treaties with its trading partners. *See* OECD Model Tax Convention, Article 5. Under the terms of the convention, a "permanent establishment" is generally defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." OECD Model Tax Convention, Articles 5, 7.

Moreover, the legislation would define "physical presence" to include businesses that assign one or more employees to the state, use an exclusive agent in the state or lease or own tangible property or real property in the state.

The legislation would cover those taxes imposed directly on a business such as corporate income taxes, gross receipts taxes, franchise taxes, single business taxes, capital stock taxes, and business and occupation taxes. It does not apply to personal income taxes, direct or indirect transaction taxes (e.g., sales and use taxes based on gross receipts) or to state taxes based on gross insurance premiums.

The legislation would identify certain taxable activities giving rise to sufficient nexus, such that states and localities would be authorized to impose business activity taxes only on companies that lease or own property, employ employees, or use certain services of an in-state person in a taxing jurisdiction.

The legislation would protect certain activities in addition to solicitation. The legislation would protect from taxation businesses that merely furnish information to customers or affiliates in the state, cover events or gather information in the state, or engage in business activity directly related to the potential or actual purchase of goods or services within the state if the final decision to purchase is made outside the state. In other words, protections primarily apply to situations where the business is patronizing the local market (i.e., being a customer), and thereby generating economic activity in the state that produces other tax revenues for the state, rather than exploiting that market.

The legislation specifies the circumstances governing the attribution of presence to a corporation. The activities and/or presence of an in-state person may be attributable to a business only when the in-state person performs activities that enhance or maintain the market in the state for the out-of-state business on an exclusive basis.[62]

Lastly, the legislation allows for *de minimis* physical presence so that physical presence under the law would not include presence in a state

[62] H.R. 1083 § 3(b)(1)(B).

for less than 15 days in a taxable year, or presence in a state to conduct limited or transient business activity.[63]

C. The State Perspective

In considering previous iterations of the present bill, states have raised a number of questions regarding federal legislation in this arena. For example:[64]

Do not the principles of federalism preclude congress from interfering in how a state chooses to structure its own tax system, particularly by altering the constitutional standard that governs when a state may tax companies conducting business within its borders?[65]

Certainly, tension exists between the authority of Congress to regulate interstate commerce and a state's authority to tax. Nevertheless, despite the fact the U.S. Supreme Court has never required a physical presence standard for imposing business activity taxes, Congress "retains ample power to modify ... [] any ... rule the Court has articulated under the Commerce Clause[] in forging a legislative solution to the problems of state taxes affecting interstate commerce."[66] This is because Congress has been given the authority to ensure that interstate commerce is not burdened by state action.[67] A state, on the other hand, is free to determine what type of tax to impose, how to apportion the income that is taxed in the state, and which types of expenses will result in credits or deductions, among other things, within these jurisdictional standards.

By limiting a state's tax base, small, would not in-state corporations bear a disproportionate tax burden when compared to large

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[63] H.R. 1083 § 3(b)(2)(A).

[64] The examples given are by no means exhaustive and are drawn from but one submission in opposition to one bill. Rather, the questions and the accompanying responses are merely modern manifestations of the arguments at play since the passage of P.L. 86-272 and the issuance of the Congressional Willis Commission report.

[65] *See* Ltr. from the National Governors Association to the Senate Finance Committee, dated June 1, 2006. A similar argument was raised during a recent hearing before the House of Representatives Subcommittee on Commercial and Administrative Law. *See* 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 (Feb. 4, 2010).

[66] Testimony of Walter Hellerstein, Before the Subcommittee on Commercial and Administrative Law, *A Primer on State Tax Nexus: Law, Power, and Policy* (Feb. 4, 2010).

[67] *See* U.S. CONST. art. I, § 8, cl. 3.

out-of-state corporations that could compete for customers and earn revenue in a state without incurring tax liability?[68]

As stated above, businesses, including small businesses, generally want to pay their fair share of taxes where they receive direct benefits and protections, i.e., where they have substantial nexus with the taxing state in the form of physical presence. BATSA 2009 would not require small businesses to pay *more* tax to a particular state in which they have physical presence. Instead, the bill would eliminate the considerable variations between state business activity taxes which small businesses are finding "inordinately burdensome and difficult to anticipate" and which "significantly inhibit their ability to engage in commerce."[69]

Lastly, could not the legislation result in a loss of state tax revenue? (One survey released by the National Governors Association in 2005 found that a similar bill would cost states in the billions annually.)[70]

Not surprisingly, different studies have touted different results.[71] Empirical data showing where the revenue losses would come from is hard to come by. One reason is that many states do not impose income taxes on businesses absent physical presence in the state. Another is that states will certainly enact legislation responding to BATSA 2009 in order to capture revenue from out-of-state corporations which are enhancing or maintaining a market within the state. Numeric discrepancies aside, rendering unto Caesar what is Caesar's necessitates knowing what in fact belongs to Caesar. In other words, how can a state bemoan the denial of what it was never fairly entitled to collect?

III. CONCLUSION

"This effort by a large number of States to impose business activity taxes based on economic presence has the potential to open a Pandora's Box

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[68] *See* Ltr. from the National Governors Association to the Senate Finance Committee (June 1, 2006).

[69] Hon. Nydia M. Velázquez, Chairwoman, News from the Committee on Small Business, *Committee Examines Business Activity Taxes and their Effects on Small Firms* (Feb. 14, 2008).

[70] *See Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States*, National Governors' Association (Sept. 26, 2005).

[71] *See, e.g.*, *Response to the National Governor Association Estimates of the State and Local Tax Impact of H.R. 1956*, Council on State Taxation (Oct. 6, 2005); Ernst & Young, *Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections* (July 25, 2006). *But see* Congressional Budget Office Cost Estimate, *H.R. 1956 Budget Activity Tax Simplification Act of 2005*.

of negative implications for businesses" and "[f]or many businesses, this will serve as a death knell for growth and expansion."

So spoke Senator Crapo in support of the Business Activity Tax Simplification Act of 2007 and in response to the proliferation of state court decisions and state legislative actions establishing the principal of economic nexus.[72] These echoes of Senator Byrd's portent continue to reverberate over fifty years later as evolving technology and a shifting economy inspire states to find new ways to answer the old question: on what basis can a state tax a business on that business' purely interstate activities?

The answer, however, should come from Congress:

"The solution to these problems ought not to rest on the self-serving determination of the States of what they are entitled to out of the Nation's resources. Congress alone can formulate policies founded upon economic realities, perhaps to be applied to the myriad situation involved by a properly constituted and duly informed administrative agency."[73]

The answer should be BATSA 2009.

[72] Sen. Crapo (ID), CONG. REC. (July 28, 2007) at S8696.
[73] *Northwestern Cement*, 358 U.S. at 477 (Frankfurter, J., dissenting).

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TENNESSEE EXPRESS

April 11, 2011

Chairman Howard Coble
Ranking Member Stephen Cohen
House Judiciary Committee
Subcommittee on Commercial and Administrative Law
517 Cannon House Office Building
Washington, DC 20515

Re: Hearing on H.R. 1439, The Business Activity Tax Simplification Act of 2011

Dear Chairman Coble and Ranking Member Cohen:

I am the CEO of Tennessee Commercial Warehouse ("TCW"), a Tennessee company founded in 1948. I am writing to respectfully urge your Subcommittee and the full House Judiciary Committee to act quickly to mark-up and favorably report out H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA").

TCW was founded as a warehousing business. In the years since, we have expanded our operations to include consolidation and distribution services, intermodal operations, dedicated transportation services and specialized transportation services. TCW is headquartered in Nashville, but we also have operations and employees in Memphis and Kingsport.

The business activity tax nexus issue is a priority for TCW. As you know, the issue relates to the circumstances in which a state may properly assess income-based taxes against a non-resident business. Traditionally, the states and the courts accepted the historic principle that a business must have a "physical presence" in a state before that state may assess such tax. More recently, some states have abandoned the traditional physical presence nexus standard and have attempted to assert a right to tax non-resident businesses based on a theory called "economic nexus," which claims authority to tax the income or gross receipts of companies who have merely customers, but no physical presence, in the taxing jurisdiction. Such efforts by states to unconstitutionally expand their taxing authority have led to unfairness and uncertainty, increased compliance costs, hindered business expansion, put companies at risk of duplicative over-taxation and threatened revenue collections of states that fully comply with constitutional nexus requirements.

BATSA would provide a much-needed bright-line physical presence nexus standard that is fair, clear and predictable. Enactment of the bill would eliminate confusion for companies that operate in interstate commerce, resulting in less litigation, fewer nexus audits, less tax compliance guesswork and, thus, greater investment in business growth and jobs.

This problem has reached a critical point and should be addressed by Congress. TCW believes that BATSA provides the appropriate solution and would foster the growth and development of our company and other Tennessee companies that operate in interstate commerce.

Thank you for your attention to this issue.

Sincerely,

Scott George

Scott George
Chief Executive Officer

usbank.com

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Minneapolis, MN 55402

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

April 12, 2011

Re: Hearing on H.R. 1439: The Business Activity Tax Simplification Act of 2011

Dear Chairman Coble and Ranking Member Cohen:

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—H.R. 1439, the Business Activity Tax Simplification Act of 2011 ("BATSA").

U.S. Bancorp (NYSE: USB), with $308 billion in assets as of Dec. 31, 2010, is the parent company of U.S. Bank N.A., the fifth largest commercial bank in the United States. The company operates 3,069 banking offices in 25 states as well as 5,310 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. 1439 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. 1439 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. 1439 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 enacted, which will be assessed against any business taxpayer which, in the Department's opinion, has 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

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

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.

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.

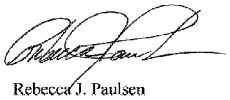
Conclusion

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. 1439, and I respectfully urge your support.

If you have any questions, please feel free to contact me at 612-303-4347.

Sincerely,



Rebecca J. Paulsen
VP, Sr. State Tax Director

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[2] Id.

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 H.R. 1439: The Business Activity Tax Simplification Act of 2011
April 13, 2011

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 Courts, 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 2011 ("BATSA"), H.R. 1439, and respectfully urge the Subcommittee to act quickly to favorably report the bill to the full Committee.

BATSA, introduced by Reps. Bob Goodlatte (R-VA) and Bobby Scott (D-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 business 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.

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[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 Courts, Commercial and Administrative Law Subcommittee, to enact BATSA.

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