BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2013

HEARING

BEFORE THE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

OF THE

COMMITTEE ON THE JUDICIARY HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

H.R. 2992

FEBRUARY 26, 2014

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BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2013

WEDNESDAY, FEBRUARY 26, 2014

HOUSE OF REPRESENTATIVES,

SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

COMMITTEE ON THE JUDICIARY,

Washington, DC.

The Subcommittee met, pursuant to call, at 3:01 p.m., in room 2141, Rayburn Office Building, the Honorable Spencer Bachus (Chairman of the Subcommittee) presiding.

Present: Representatives Bachus, Goodlatte, Farenthold, Marino, Johnson, and DelBene.

Staff present: (Majority) Anthony Grossi, Counsel; Rachel Wolbers, Legislative Assistant for Rep. Farenthold; Philip Schwartzfager, Legislative Director for Rep. Bachus; Ashley Lewis, Clerk; (Minority) Perry Apelbaum, Minority Staff Director & Chief Counsel; Norberto Salinas, Counsel; Slade Bond, Legislative Counsel for Rep. Johnson; and Rosalind Jackson, Professional Staff Member.

Mr. BACHUS. The Subcommittee on Regulatory Reform, Commercial and Antitrust Law hearing will come to order. Without objection, the Chair is authorized to declare recesses of the Committee at any time.

I do want to tell the panel that events on the House floor have been changing this week. We were going to consider this bill or that bill out of this Committee on the floor, and they keep moving that around, and so, we usually do not initially set a hearing for 4 p.m. We usually have them earlier, but we try to do that. And now we find we are going to be on the floor a little later on, so this hearing may be fairly compact. But let me give an opening statement.

Today we will hear testimony regarding the Business Activity Tax Simplification Act of 2013, or BATSA. The purpose of this bill, which I have co-sponsored, is to establish a clear, uniform, and predictable framework for states and businesses with regard to the application of business activity taxes. States have broad authority to assess taxes on individuals, property, and businesses that originate from the basic principles of federalism.

The Constitution has always conferred upon Congress the responsibility to protect against undue burdens to interstate commerce to allow our free market economy to function across state borders. There is a thoughtful balance that must be struck between these two competing interests. And when acting in interstate commerce matters, Congress must be sure to exercise its power with great care and precision.

The issue before us deals with state taxation policies that affect out-of-state businesses. The Judiciary Committee has collected much testimony and will receive more testimony today that documents the frustrations of small businesses with state taxing regimes that have been increasingly aggressive in their efforts to collect revenue from out-of-state businesses.

Small businesses can be easy targets because they have little or no direct representation in the state and do not have the resources to fight. And I think two of our witnesses are going to be fantastic examples of this. In addition, court decisions have created confusing and ambiguous guidelines for what actions taken by an out-of-state business will be sufficient for a state to gain authority to impose business taxes.

As a result of unclear judicial precedent, businesses are often forced to spend scarce resources on lawyers and accountants to either calculate their tax liability or defend against improper tax bills, and often the only option is just simply to write a check. It is not the right thing to do, but it is certainly the economically right thing to do, and that should not be the case.

BATSA will bring needed consistency and predictability to what we know as nexus standard issues where an out-of-state business is subject to business activity taxes. It will enable small businesses in particular to more accurately determine their tax liability without impeding the traditional ability of states to assess taxes on enterprises that truly have an active presence within their borders. This legislation is a balanced approach that respects states' prerogatives and preserves the seamless interconnected national economy that we all benefit from.

I now recognize the Ranking Member, Mr. Hank Johnson of Georgia, for his opening statement.

[The bill, H.R. 2992, follows:]

I

113TH CONGRESS
1ST SESSION

H. R. 2992

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

IN THE HOUSE OF REPRESENTATIVES

AUGUST 2, 2013

Mr. SENSENBRENNER (for himself, Mr. GOODLATTE, Mr. SCOTT of Virginia, Mr. BACHUS, Mr. CHABOT, Mr. DUNCAN of South Carolina, Mr. JORDAN, and Mr. HASTINGS of Florida) introduced the following bill; which was referred to the Committee on the Judiciary

A BILL

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

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "Business Activity Tax Simplification Act of 2013".

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

(a) SOLICITATIONS WITH RESPECT TO SALES AND TRANSACTIONS OF OTHER THAN TANGIBLE PERSONAL PROPERTY.—Section 101 of the Act entitled "An Act relating to the power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto", approved September 14, 1959 (15 U.S.C. 381 et seq.), is amended—

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

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

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

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

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

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

"(3) the furnishing of information to customers or affiliates in such State, or the coverage of events or other gathering of information in such State by such person, or his representative, which information is used or disseminated from a point outside the State; and

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

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

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

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

"(2) by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State 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, 2014, 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 2013. 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.

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

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

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

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

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

(c) TAXABLE PERIODS NOT CONSISTING OF A YEAR.—If the taxable period for which the tax is imposed is not a year, then any requirements expressed in days for establishing physical presence under this Act shall be adjusted pro rata accordingly.

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

(e) EXCEPTIONS.—

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

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

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

(2) TAXATION OF PARTNERS AND SIMILAR PERSONS.—This section shall not be construed to modify or affect any State business activity tax liability of an owner or beneficiary of an entity that is a partnership, a 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, 2014.

○

Mr. JOHNSON. Thank you, Mr. Chairman, for holding this hearing today. I find it fortuitous that as I assume the Ranking Member position, the Subcommittee turns to addressing state taxation issues. I hope this is the beginning of a series of discussions focusing on state taxation.

Over the past several Congresses, I have worked closely with my colleague, Representative Howard Coble, on a common sense solution to simplify and reduce taxes for so many Americans. This Congress we introduced H.R. 1129, the "Mobile Work Force State Income Tax Simplification Act of 2013." H.R. 1129 is identical to legislation passed by the House last Congress. I hope that this bipartisan legislation will be considered at the appropriate time, and I look forward to working with the Chair on it.

I also look forward to this Committee addressing the remote sales tax issue next week. I have long supported leveling the playing field when it comes to sales tax collections. That is why I support H.R. 684, the "Marketplace Fairness Act." Although I would prefer a legislative hearing on that bill, I welcome any movement toward addressing the remote sales tax issue.

There are other issues and related legislative proposals this Subcommittee can discuss. As the former Chair of the Subcommittee on Courts and Competition Policy, I look forward to future hearings on some of those issues, especially on antitrust issues, another area right for this Subcommittee's attention.

But today, we focus on H.R. 2992, the "Business Activity Tax Simplification Act of 2013." This legislation would establish a physical presence standard, which must be met before states can impose a business activity tax. Proponents of the legislation contend that businesses need more certainty in determining what activities are taxable, and that a uniform standard would provide that. Opponents of the bill argue that states should determine what activities are taxed within their borders, and that the physical presence standard created in this bill would invite tax evasion.

Although I have supported similar legislation in the past, I am taking a step back this time to look more closely at the legislation and to hear today's testimony. I hesitate because of the impact this legislation may have on state and local governments. Last Congress, the Congressional Budget Office estimated that identical legislation would lead to about $2 billion in lost annual revenues with the potential for additional losses in subsequent years.

When we consider legislation which will have that large of an impact, we need to determine if we need to simply revise the language. We should also study whether there are alternative methods which accomplish the same goal of providing more certainty for businesses while minimizing any impact on or state and local governments.

I look forward to hearing from the witnesses, and again I thank the Chairman for holding today's hearing. Thank you, and I yield back.

Mr. BACHUS. Thank you. Without objection, all Members' opening statements will be made a part of the record.

[The prepared statement of Mr. Johnson follows:]

Statement of the Honorable Hank Johnson for the Hearing on H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

Wednesday, February 26, 2014, at 4:00 p.m.
2141 Rayburn House Office Building

Thank you Mr. Chairman for holding this hearing today.

I find it fortuitous that as I assume the Ranking Member position, the Subcommittee turns to addressing state taxation issues. I hope this is the beginning of a series of discussions focusing on state taxation.

Over the past several Congresses, I have worked closely with my colleague Representative Howard Coble on a common-sense solution to simplify and reduce taxes for so many Americans. This Congress we introduced H.R. 1129, the Mobile Workforce State Income Tax Simplification Act of 2013.

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There are other issues and related legislative proposals this Subcommittee can discuss. As the former Chair of the Subcommittee on Courts and Competition Policy, I look forward to future hearings on some of those especially on antitrust issues, another area ripe for this Subcommittee's attention.

But today, we focus on H.R. 2992, the "Business Activity Tax Simplification Act of 2013." This legislation would establish a physical presence standard which must be met before states can impose a business activity tax.

Proponents of the legislation contend that businesses need more certainty in determining what activities are taxable and that a uniform standard would provide that. Opponents of the bill argue that states should determine what activities are taxed within their borders and that the physical presence standard created in this bill would invite tax evasion.

Although I have supported similar legislation in the past, I am taking a step back this time to look more closely at the legislation and to hear today's testimony.

I hesitate because of the impact this legislation may have on state and local governments. Last Congress, the Congressional Budget Office estimated that identical legislation would lead to about $2 billion in lost annual revenues with the potential for additional losses in subsequent years.

When we consider legislation which will have that large of an impact, we need to determine if we need to simply revise the language.

We should also study whether there are alternative methods which accomplish the same goal of providing more certainty for businesses while minimizing any impact on our state and local governments.

I look forward to hearing from the witnesses. Again, I thank the Chairman for holding today's hearing.

[The prepared statement of Mr. Goodlatte follows:]

Statement of Judiciary Committee Chairman Bob Goodlatte
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
Legislative Hearing on H.R. 2992, the
"Business Activity Tax Simplification Act of 2013"
Wednesday, February 26, 2014 at 4:00 p.m.
(FINAL)

The uneven and unclear application of business activity taxes by States has created a significant barrier to growth for businesses. The group that is disproportionately affected by State tax uncertainties is small businesses, which do not have the resources to engage in complex tax planning or litigate aggressive tax bills. Small businesses provide the pillars of our economic growth, and we should ensure that these businesses have every opportunity to succeed.

Today's hearing on the "Business Activity Tax Simplification Act of 2013" or "BATSA" focuses on an important measure that will help to ensure small businesses are able to dedicate their time and efforts on growing their businesses and creating jobs rather than navigating complex minefields of State tax laws. I co-sponsored BATSA this Congress and have sponsored similar forms of this legislation for over a decade. The issue of disparate, aggressive, and ambiguous application of State business activity taxation that led to my introduction of a similar bill in 2003 has only grown in the intervening years.

Since 2003, the Judiciary Committee has received testimony that described States holding company trucks until they paid questionable tax bills, court rulings that concluded the display of a sign bearing a franchise's name is sufficient to trigger taxes for an out-of-state franchising company, and States attempting to tax out-of-State credit card companies because in-state residents possessed the companies' credit card. The record surrounding BATSA is long, detailed, and compelling. I am pleased that Chairman Bachus is holding today's hearing to update and extend the Committee's record on this important bill.

I also want to thank today's witnesses for appearing before us, particularly Mr. Vegas and Mr. Simmons who traveled quite a distance to relay their small businesses' interactions with State taxing authorities. I look forward to their testimonies and our other witnesses' testimonies on this important measure.

Thank you Mr. Chairman, and I yield back the balance of my time.

# # #

[The prepared statement of Mr. Conyers follows:]

Statement of the Honorable John Conyers, Jr. for the Hearing on H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

Wednesday, February 26, 2014, at 4:00 p.m.
2141 Rayburn House Office Building

H.R. 2992, the "Business Activity Tax Simplification Act of 2013," imposes a physical presence standard upon which states must follow when taxing business activities.

I have opposed identical legislation in the past and continue to do so for the following reasons.

First, this bill will drastically alter the state tax landscape by overriding well-established laws.

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.

This legislation unfortunately does not balance these competing interests.

Most states apply an economic presence standard, whereby a company is taxed based on whether it conducts sufficient business within the State. And many states have employed this standard for nearly 60 years.

The business community argues that the widespread use of the economic presence standard has led to much confusion.

In its place it urges upending long-settled state tax practices by implementing the physical presence standard reflected in H.R. 2992.

Second, this bill goes far beyond just imposing a new unworkable standard for business activity taxes. H.R. 2992 fosters additional ambiguities with new exceptions and a *de minimis* standard.

The bill favors big multistate corporations at the expense of small and local businesses. It will encourage tax evasion by creating opportunities for nationwide businesses to structure corporate affiliates and transactions to avoid paying their fair share of state taxes.

The bill creates a significant loophole by preventing states from imposing business activity taxes on businesses which have less than 15 days of physical presence within the state. This will shift the state corporate income tax burden onto local, small businesses and manufacturers, and natural resource and service industries. In other words, the types of businesses that pay local property and payroll taxes.

We should not be placing additional burdens on our local businesses. But that is what this legislation effectively does.

Finally, this bill will eviscerate state revenues.

Just last Congress the Congressional Budget Office estimated that identical legislation would reduce state tax revenues by "about *$2 billion* in the first full year following enactment and at least that amount in subsequent years."

The CBO did not stop there. It also concluded that there would likely be additional revenue losses because corporations would take advantage of the new standard and loopholes the legislation established.

Consider the impact of a potential loss of more than $2 billion annually for states. That amount of losses would force states to increase taxes and make draconian cuts to valuable governmental programs and services.

The concept behind H.R. 2992 is seriously flawed. And I urge my colleagues to oppose this bill.

Mr. BACHUS. Before we introduce today's witnesses, without objection, I would like to submit for the record letters and written testimony in support of BATSA from the International Franchise Association, Pro-Help Systems, Fischer and Wieser Specialty Foods, Partnership for New York City, the missing Computing Technology Industry Association, and the U.S. Chamber of Commerce.

[The information referred to follows:]

INTERNATIONAL FRANCHISE ASSOCIATION

February 26, 2014

The Honorable Spencer Bachus
U.S. House of Representatives
House Committee on the Judiciary
Chairman, Subcommittee on Regulatory Reform, Commercial and Antitrust Law
517 Cannon House Office Building
Washington, DC 20515

The Honorable Hank Johnson
U.S. House of Representatives
House Committee on the Judiciary
Ranking Member, Subcommittee on Regulatory Reform, Commercial and Antitrust Law
517 Cannon House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act of 2013 (H.R. 2992)

Dear Chairman Bachus and Ranking Member Johnson:

The International Franchise Association (IFA) would like to express strong support for the Business Activity Tax Simplification Act ("BATSA") (H.R. 2992). BATSA would answer the need for a fair, clear and uniform nexus standard for the imposition of business activity taxed by states and localities. We want to thank you for convening this hearing.

Who we are:

The International Franchise Association is the world's oldest and largest organization representing franchising worldwide. Celebrating over 50 years of excellence, education and advocacy, IFA works through its government relations and public policy, media relations and educational programs to protect, enhance and promote franchising. Through its media awareness campaign highlighting the theme, Franchising: Building Local Businesses, One Opportunity at a Time, IFA promotes the economic impact of the more than 825,000 franchise establishments, which support nearly 18 million jobs and \$2.1 trillion of economic output for the U.S. economy. IFA members include franchise companies in over 300 different business format categories, individual franchisees and companies that support the industry in marketing, law and business development.

Why the Franchise Industry Supports BATSA:

While the United States Supreme Court, through its ruling in *Quill Corp. v. North Dakota*, justified the prohibition of states forcing out-of-state corporations to collect certain taxes unless it had established a physical presence in the taxing state, states have in recent years ignored the ruling and begun establishing an economic nexus standard for taxation. This has created tremendous hardships and confusion for businesses that use the franchise business model to expand their brand, while not necessarily the presence of their corporate entity, across state lines.

Most franchisors own no property in the state in which their franchisees operate, do not maintain offices there and employ no residents of those states. A franchisor's employees may make occasional visits to its franchisee's place of business to assist the franchisee in opening his or her business and to inspect the franchisee's performance and furnish training advice and guidance, but the duration of such visits normally is limited to a few hours or days. The services that a franchisor furnishes to its franchisees, and communication among a franchisor and its franchisees, are implemented almost entirely at the franchisor's principal offices and through interstate communications media. Most franchisors do not rely on the states of their franchisees' domicile for any services and impose no costs on those states. Meanwhile, like any other enterprise domiciled in a state, a franchisee operating there would pay taxes, be involved in supporting community activities and create economic opportunities for employees and suppliers who would directly benefit from the existence of the enterprise.

Enactment of BATSA is important to the franchise industry because of the business relationship between a franchisor and its franchisees. Central to that relationship is a shared trade identity. That shared trade identity is established and maintained by the franchisor's license of its trademark, trade dress and other intellectual property (*i.e.*, intangible property) to each of its franchisees. Thus, each of the hundreds of thousands of franchise relationships that exist in the U.S. involves a license of intangible property. The great majority of those licenses cross state lines.

The franchise relationship evolved over the last half century with the understanding that the franchisor is not subject to state income taxes (other than those imposed by the franchisor's domicile state and any state where is maintains physical presence) on the royalty income paid to the franchisor by franchisees located in a different state. Prior to the late 1980s, with rare exception, states did not seek to tax such income unless the franchisor clearly established a traditional nexus by owning or leasing real estate, operating its own outlets, or maintaining an office or employees in the taxing state.

Franchise brands exist across a multitude of political boundaries in most franchise systems, but the franchisor is often a single entity with a clearly defined corporate residence. Some state revenue officials and, increasingly, legislators view the presence of a franchised outlet of a national or regional brand in their state, intentionally or not, as sufficient for the establishment of economic, rather than physical, nexus of the out-of-state franchisor. It has been incorrectly argued that the mere presence of intangible property in their jurisdiction satisfies the "substantial nexus" requirement under the Commerce Clause for the imposition of state income and related business activity taxes. Such arguments radically expand the classes of persons, relationships and transactions potentially subject to state income taxation, and threaten the livelihoods of hundreds of thousands of entrepreneurs who have chosen franchising as the route to small business ownership.

The issue has enormous implications for the businesses engaged in interstate franchising, a rapidly expanding part of the American economy. If permitted, such assessments would subject licensors of intangible property in interstate commerce to income taxation by every state in which goods or services exploiting the licensed intangible property are sold. If a tax return is not filed, no statute of limitations will limit the period for which taxes, interest and penalties may be due. Such a result would represent a radical departure from the historical understanding of the reach of taxing authority and a significant increase in the tax liability and burden of compliance of thousands of American small businesses.

If every state where a franchisor has granted franchises may tax its income attributable to that state, non-resident franchisors will be subject to costly compliance burdens and ever escalating taxes. Under these circumstances, there is no doubt that franchisors will be forced to consider passing this cost of business on to their franchisees by increasing the royalty fees. Under this scenario the party most harmed is the resident franchisee. Thus, enactment of BATSA is critical for thousands of businesses, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Conclusion:

The franchising business model is at risk if aggressive nexus audits continue to threaten the ongoing relationship between franchisors and franchisees. While the two are separate entities, the steps necessary to maintain the shared brand do not constitute a presence in every state where that brand appears. The cost associated with compliance and preparation of the returns is significant, and is a major financial burden for smaller franchisors and in many cases eclipses the taxes being paid.

If every state where a franchisor has granted franchises may tax its income attributable to that state, franchisors will be subject to costly compliance burdens and overlapping taxes. Thus, enactment of BATSA is critical for thousands of businesses, including franchising companies, their franchisees and other licensors and licensees of intangible property across state lines.

Thank you for considering this written testimony.

Sincerely,

Stephen J. Caldeira
President and CEO

WRITTEN STATEMENT OF

CAREY J. (BO) HORNE
PAST PRESIDENT

and

KATHERINE S. HORNE
PAST VICE PRESIDENT

PROHELP SYSTEMS, INC.
418 East Waterside Drive
Seneca, SC 29672

on

"H.R. 2992, the Business Activity Tax Simplification Act of 2013"

before the

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

of the

COMMITTEE ON THE JUDICIARY
UNITED STATES HOUSE OF REPRESENTATIVES

February 26, 2014

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 and quick enactment of a legislative solution as set forth in H.R.2992, The Business Activity Tax Simplification Act of 2013 ("BATSA"), 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 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.**

<u>The Impossible Situation</u>:

As documented by numerous large businesses, including Smithfield Foods during the 2004 "BATSA" hearing in the House Judiciary Committee, 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 <u>Complete Auto Transit</u>.

As indicated earlier, though, the states simply ignore the **<u>total impossibility</u>** 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 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**.

<u>Our Experience is *Not* an Isolated Case:</u>

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

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 House Judiciary Committee 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 also have 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 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 a federal legislative solution, like "BATSA". 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 over ten years, we know the Business Activity Tax Simplification Act is **<u>exactly</u>** what small businesses need. We urge the House Judiciary Committee to use its full resources to insure prompt enactment of such legislation. 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.*

* 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.

Letter of Support by Mark B. Wieser
Founder of Fischer & Wieser Specialty Foods, Inc.
For passage of
H. R. 2992, The Business Activity Tax Simplification Act of 2013

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

Chairman Spencer Bachus, Ranking Member Hank Johnson and the Honorable Members of the Subcommittee, I would like to commend you for holding a hearing on H.R. 2992, the Business Activity Tax Simplification Act of 2013 ("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 was shipped to the United Kingdom in 2012. We have also exported containers to Germany in 2013 and Costco has introduced us to Taiwan this year. 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-five 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. For us to pay any state 4.8% of gross sales has a tremendous impact on our ability to earn a profit.

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 our appeal against the state of Washington, 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.

Since our last submission of this supporting evidence our status within the state of Washington has changed. Last year we hired a firm that was unfortunately based in that state. Their goal is to increase sales to all Costcos. Being based in Washington did subject us to their Business and Occupation Tax according to their rules and interpretations. Consequently, we were forced to pay a tax of .0484 on our gross sales shipped to that state. Meanwhile, their department of revenues is hinting that we might owe back taxes since winning our appeal in 2010 as they have since changed their internal rules. Now it seems we are in this fight again which takes time and effort that we and hundreds of smaller companies simply cannot afford.

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
Fischer & Wieser Specialty Foods, Inc.
www.jelly.com
411 South Lincoln Street
Fredericksburg, Texas 78624
mark.wieser@jelly.com
830-990-8256
830-997-7194 ex 8256
Fax 830-997-0455

One Battery Park Plaza New York, NY 10004-1479
T 212 493 7400 F 212 344 3344 www.pfnyc.org

PARTNERSHIP
for New York City

TESTIMONY SUBMITTED TO THE HOUSE JUDICIARY SUBCOMMITEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

HEARING ON H.R. 2992:
THE "BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2013"

Wednesday, February 26, 2014

KATHRYN WYLDE
PRESIDENT & CEO
PARTNERSHIP FOR NEW YORK CITY

Thank you, Chairman Bachus and Members of the Subcommittee for the opportunity to submit written testimony.

The Partnership for New York City is a nonprofit organization of international and regional business leaders who partner with government and other sectors to promote job creation, economic growth and public education. We strongly support H.R.2992, the Business Activity Tax Simplification Act of 2013 ("BATSA") and respectfully urge Congress to enact the bill into law this year.

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 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. 2992 would alleviate the burden that many interstate businesses face and help promote economic growth across the country.

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 supply the infrastructure and services necessary to accommodate these companies, and tax the business community accordingly. 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. Economists agree that income is earned where a business employs its labor and capital and that is where they should be liable for business taxes.

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 such as New York City that are absorbing the costs associated with the demands of major commercial operations.

Thank you for your consideration.

CompTIA

The Computing Technology Industry Association

Testimony Before the

House Judiciary Committee

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

H.R. 2992

"Business Activity Tax Simplification Act of 2013"

February 26, 2014

Introduction.

Good afternoon, Chairman Bachus, Ranking Member Johnson, and distinguished members of this Subcommittee. This testimony is submitted on behalf of the Computing Technology Industry Association (CompTIA), which represents a significant number of small computer services businesses called Value Added Resellers, also known as "VARs".

I want to thank Chairman Bachus 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. 2992, the "Business Activity Tax Simplification Act of 2013"

Small businesses are the backbone of the American economy. According to the Small Business Administration Office of Advocacy, there are approximately 28 million small businesses employing half of the U.S. 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.

CompTIA is the voice of the world's information technology (IT) industry. As a non-profit trade association advancing the global interests of IT professionals and companies, we focus our programs on four main areas: Education, certification, advocacy and philanthropy. CompTIA's members include small computer services businesses called Value Added Resellers (VARs), as well as most major computer hardware manufacturers, software publishers, and IT service providers. We are driven by our members and led by an elected board of industry professionals.

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.

The Issue.

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

One of the basic principles of the *Quill* decision is fairness. That is, it is principally unfair and burdensome for a state to require a business to collect sales and use taxes when that business has no physical presence in the taxing state. The 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.

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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 and impose 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* continues to grow in usage. Consider the example of the delivery of business applications online to a user in State X, which has business applications 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.

Legislation.

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Accordingly, we call on Congress to pass H.R. 2992, the "Business Activity Tax Simplification Act of 2013," 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 the IT industry and our membership – especially our small technology company members, which rely more heavily on income from the remote provision of interstate services.

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Statement of the U.S. Chamber of Commerce

ON: H.R. 2992, THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2013

TO: HOUSE JUDICIARY COMMITTEE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

DATE: FEBRUARY 26, 2014

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

INTRODUCTION

Chairman Bachus, Ranking Member Cohen, and members of the Subcommittee, the U.S. Chamber of Commerce thanks you for the opportunity to comment on H.R. 2992, the "Business Activity Tax Simplification Act of 2013." The Chamber strongly supports this bill which would establish a bright-line, physical presence nexus standard for when a state can levy an income tax on an out-of-state business.

BACKGROUND

A multi-state business generally is subject to tax only in those states where the business has a physical presence, such as an office or employees. Increasingly, states have attempted to apply an "economic nexus" standard to collect taxes from businesses located in other states – even though such businesses have no physical presence therein. The effort by states to apply an economic, rather than physical, nexus standard has led to uncertainty and widespread litigation.

H.R. 2992 would provide a bright line, uniform, physical presence standard which must be met before any state can levy income or business activity tax on a business located outside the state. H.R. 2992 would provide predictability and certainty to businesses as to what their tax liabilities are and to which states those tax liabilities have been rightfully incurred.

SUBSTANTIAL NEXUS: PHYSICAL PRESENCE VS. ECONOMIC PRESENCE

Under the Commerce Clause of the U.S. Constitution, Congress is responsible for ensuring the free flow of goods and services among the states. Thus, a state tax generally may be levied upon products and/or services conducted through interstate commerce only if an out-of-state business has "substantial nexus" with the taxing state.[1]

The U.S. Supreme Court, in Quill Corp. v. North Dakota,[2] a case involving sales and use tax collection, held that a state could not levy taxes on an out-of-state business unless that business had more than a de minimis physical presence within the taxing state. With respect to income taxes, the Interstate Income Tax Act of 1959 (Public Law 86-272) prohibits a state from imposing an income tax on a multistate business whose only state activities are the solicitation of orders for tangible personal property, provided that the orders are approved and filled outside the state.

Much uncertainty exists with respect to these nexus standards. Some states require a physical presence to levy a sales tax as mandated by Quill, but levy all other business taxes based an economic presence standard. The result is differing presence standards based on the type of tax imposed.

Likewise, states generally apply the physical presence standard under P.L. 86-272 in the case of businesses which produce tangible goods. However, businesses which provide services or

[1] U.S. Constitution, Article I, Section 8, Clause 3.
[2] 504 U.S. 298 (1992).

intangible products are not explicitly protected under P.L. 86-272, resulting in differing presence standards for different industries.

The disparities in tax treatment that arise under current law lead to uncertainty and unpredictability for businesses. These uncertainties can result in litigation to settle tax disputes which is costly to both the taxpayers and state governments.

PROVISIONS OF H.R. 2992

Physical Presence Standard

H.R. 2992 would codify the physical presence standard, providing that a state or locality may not impose income or other business activity taxes unless businesses have "physical presence" in the jurisdiction. The required physical presence is a bright line test that establishes tax jurisdiction where an out-of-state business has employees, has tangible or real property, or uses agents to perform certain activities within a taxing state.

Since H.R. 2992 provides that a *de minimis* physical presence would not give rise to meeting the physical presence standard, it would allow a business to send employees into a state for 15 days in any year and not subject that business to an obligation for that state's income tax. Further, under the *de minimis* rule, H.R. 2992 would allow employees to perform transitory assignments and not trigger unintended tax obligations.

These rules would provide both a clear physical presence standard and a clear standard for what activities a firm can conduct within a state that will not trigger that state's taxing power. This would provide certainty to businesses and tax administrators and would reduce compliance and enforcement costs.

Modernization of P.L. 86-272

P.L. 86-272 was enacted 55 years ago. Since then, the U.S. economy has seen significant changes. Recognizing the changes in both the services and products offered as well as the types of companies that make up our economy, H.R. 2992 would extend the longstanding protections of P.L. 86-272 to all sales or transactions, not just to sales of tangible personal property.

H.R. 2992 also would modernize P.L. 86-272 by addressing the efforts of some states to avoid the restrictions imposed by Congress in P.L. 86-272. Specifically, some states have established taxes on business activity that are measured by means other than the net income of the business. H.R. 2992 would ensure that P.L. 86-272 covers all business activity taxes, not just net income taxes.

CONCLUSION

The Chamber strongly supports H.R. 2992. By codifying the physical presence standard, H.R. 2992 would provide certainty to both businesses and tax administrators about when taxes can be levied, reducing compliance and enforcement costs. Further, by modernizing P.L. 86-272, H.R. 2992 would treat services and products offered by all businesses in a more fair and equitable manner.

Chairman Bachus, Ranking Member Cohen, and members of the Subcommittee, the Chamber applauds your leadership in conducting this hearing and thanks you for the opportunity to comment on this issue.

Mr. BACHUS. We have a distinguished panel today, and I would like to introduce our witnesses now. Having read the experiences of Mr. Vegas and Mr. Simmons and your companies, I think that the evidence will be helpful to Mr. Johnson and others as they try to decide what to do.

Mr. Vegas is the founder and president of Sage V Foods, which specializes in producing rice-based ingredients for use in processed foods, and has developed the most complete line of rice products in the industry. Prior to Sage V, Mr. Vegas managed a startup rice milling company that was a joint venture between Comet Rice and the government of Puerto Rico, and ultimately became vice president of marketing for Comet Rice.

Mr. Vegas graduated from Louisiana State University with a degree in agribusiness, and received his MBA from Harvard Business School. We welcome you.

Mr. Tony Simmons is president, CEO, director, and interim chairman of the board of McIlhenny Company. McIlhenny, okay. McIlhenny Company is 146-year-old company whose most famous product is TABASCO brand pepper sauce. I think we all know about the island and everything. Mr. Simmons is the great, great grandson of the creator of TABASCO, Edmund McIlhenny, and is the seventh family member to assume McIlhenny Company leadership, which is still family owned and operated.

Prior to accepting the position with McIlhenny Company, Mr. Simmons was president and CEO of Manitowoc Southeastern—yes, it is the crane people, right, the cranes—an independent crane distributor located in the southeast. And that company is headquartered in Wisconsin or Minnesota?

Mr. SIMMONS. Manitowoc is in Manitowoc, Wisconsin.

Mr. BACHUS. Wisconsin, okay. Mr. Simmons also serves on the board of America's Wetland Foundation. Mr. Simmons holds a degree in speech from Loyola University in New Orleans. We welcome you. And what is the name of the island?

Mr. SIMMONS. Avery Island.

Mr. BACHUS. Avery Island, that is right. I think every restaurant in the south either has tabasco sauce or, what is it, Texas Pete, that which is not a tabasco sauce.

Mr. SIMMONS. Never heard of Texas Pete. [Laughter.]

Mr. BACHUS. That is a great answer. Mr. Joseph Henchman is vice president of legal and state projects at the Tax Foundation, a non-profit 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, Fortune magazine, and a number of law review journals.

Mr. Henchman received his bachelor's degree in political science from the University of California at Berkeley and his JD from George Washington University Law School. Welcome to you, Mr. Henchman.

Mr. David Quam is deputy director of Federal relations at the National Governors Association. He has an extensive track record in development policy solutions and effectively advocating positions before Congress and the Administration to the Governors Collective

Policy Priority. Before joining the National Governors Association, he was an associate at Powell, Goldstein, Frazer, and Murphy, LLP, director of international affairs and general counsel at the International Anti-Counterfeiting Coalition, and majority counsel on the Senate Judiciary Committee's Constitution Subcommittee.

He received his BA from Duke University and his JD from Vanderbilt University School of Law.

Each of the witnesses' written testimonies will be entered into the record in its entirety, and I ask each of our witnesses to summarize his or her testimony in 5 minutes or less. And we are going to have a light which will turn yellow and then red, but if you need to go over by 20 or 30 seconds, that is fine with me, although I think the Chairman does not really like that, but I am the Subcommittee Chairman, and I do not mind it.

So at this point, we will still start with the witnesses. Mr. Vegas, we will start with you first, and then we will go down the line.

TESTIMONY OF PETE VEGAS, FOUNDER AND PRESIDENT, SAGE V FOODS, LOS ANGELES, CA

Mr. VEGAS. Okay. Okay. My name is Pete Vegas. I appreciate the opportunity to speak with you today. I will tell you I am a little concerned that I could be targeted by these states once my name becomes public, so I would hope you help me out if that happens. Otherwise, this could be a very——

Mr. BACHUS. We could pass this. That would help.

Mr. VEGAS. That would solve the problem. [Laughter.]

I hope you have had the chance to read my written testimony or will read it. Those are my words. Because I defended myself against the State of Washington, I have actually learned quite a bit about this, probably more than any businessman should know really.

Mr. BACHUS. And let me say this, and stop the time. Both your testimony and, Mr. Simmons, I mean, those are nightmare situations for not only a small business. I would actually call your business a medium-sized business. Really your experience, you are an eyewitness to this. So, you have experienced this, and you look at it, and how anyone can look at what you have gone through and think that is fair or equitable, you know, it is hard to believe that that was what we conceived when we gave states the taxing authority.

Mr. VEGAS. You know, and 5 minutes is not a lot of time, so I'm hoping there are questions and I can spend more time, yes.

So I started my company from scratch. We basically take rice and have learned to make new products from rice, have taught people how to use it. Today we sell rice flour, frozen rice, crisp rice like goes in granola bars, instant rice. We are an approved supplier in almost every major food company in the United States, so we are shipping products, you know, pretty much throughout the country.

Our sales today are about $100 million. You know, I employ over 200 people. And so from a tax standpoint—and in the last 7 years I have built 3 facilities, two in Arkansas and one in Texas. I live in California. From a tax standpoint, you know, I am an LLC. That means taxes flow straight through to me, so I pay Federal taxes.

I pay taxes in California. And then I pay taxes in the states where I have facilities and properties, like Arkansas and Texas.

In 2010, I was basically hit, you know, by the State of Washington. Washington has no income tax, so they charge what they call a business and occupation tax, which is essentially a tax on sales. It is a tax on gross receipts. And to be clear, you know, what I am talking about here are business to business taxes. I am not selling to a consumer. I am not talking about sales taxes to a consumer like you would discuss with Amazon or someone like that. I mean, to make it very clear, I am selling rice flour in bulk rail cars to a company in the State of Washington that takes my flour, blends it with other ingredients, sells a mix, you know, a batter mix basically, to a french fry company that makes French fries, that turns around sells it to a large burger chain that then sells to their franchises. So if everyone was charging taxes like the State of Washington, my flour would be taxed four times before the consumer paid a sales tax on it, okay?

As a percentage of my income, the tax that I paid in Washington is over 16 percent. That is higher than any state in the country, okay? And if you start adding up what I pay in Federal taxes and state's taxes, if I paid everyone what Washington charged me, my tax bills would be over 70 percent. And I can tell you, I cannot run a company when that much of my money is going outside.

Because I visited the state one time in 7 years, Washington basically sent me a tax bill for over $180,000. It was for 7 years back penalties and taxes. And then once you have established nexus, even though you stop the activity—I do not visit anymore—it goes another 5 years forward. So this could have easily been or would be a $300,000 kind of bill. Quite frankly, I have never seen anything like that. I was shocked. You know, I called other businesses, friends, to ask, you know, what did they know about this. It is not known by people who have not been hit yet, but it is becoming more and more prevalent. I had to hire an attorney to explain it to me, you know.

And I can tell you, a company like mine cannot afford to try to understand every oddball state in 50 different states. I mean, I had a tax accountant last year that wanted to charge me over $100,000 to do my taxes, okay? Imagine if I had to deal with 50 states coming at me. It is just impossible.

Every attorney in the State of Washington literally turned me down. They said, Pete, it is a waste of your money to fight these people. But, you know, I am bullheaded. I was wronged. I did it anyway. I mostly defended myself, okay? I went through three appeal processes and eventually won, you know, but that was a huge effort on my part. It took a lot of time away from my business. It is not something I could do every time a state comes after me.

And the kind of stuff that Washington tried to trip me up on, which I think is common in other states so that you understand, the issues are did I have brokers in the state, had I attended trade shows in the state, you know, did I sell on a delivered basis instead of an FOB basis, could a customer reject my product at destination, had I sent a service technician to, like, repair a rail car or help them use the product, did I ship on company-owned trucks, do I have any product warehoused in the states. Any of these things would have established nexus.

My actual fights in court were mostly related to my visit, you know, how many times did I visit. We determined it was one, you know, and then I won that case. The next time I went they focused on the fact that I had shipped on company-leased rail cars, which meant in their mind I had leased equipment in the state. In both cases, you know, I prevailed mostly because in the State of Washington, they have a statute that says to establish nexus, the business activity must be related to or maintaining a market in the state, okay? And in both cases I proved it did not, you know, which means had I made a sales call, a serious sales call, in that one visit, they may have established nexus with that.

And basically because I defended myself, I learned quite a bit about the law itself. And what I have learned is there is really nothing to date that prevents states from collecting all of their revenue from outsiders. I mean, if you are a politician and you are running a state, it is hard to cut your budget. It is hard to reduce expenses. It is hard to raise taxes on your voters. It is very easy to take advantage of somebody from the outside because we have no recourse. We have no vote. And that is exactly what you are seeing more and more of. I mean, it is the old story of taxation without representation. I mean, it is why our country is here today and not part of Great Britain.

I studied the Constitution and Supreme Court rulings. You know, the commerce clause is a pretty simple clause really. It basically gives Congress the power to regulate commerce with foreign nations and among the several states and with the Indian tribes. It makes it very clear that this is Congress' job, not the job of the Supreme Court. Everyone seems to understand that a big part of this is to prevent the kind of problem we have today, which is a deterrent to interstate commerce. If this goes on, you know, it is going to be a huge problem and it is going to prevent interstate commerce.

The last time the Supreme Court visited this, and I am sure you will hear more from people that know more about it, was the Quill case. And it actually required a physical presence. The Supreme Court has never issued a ruling that allowed nexus without a physical presence.

In my particular situation, I argued the four-pronged test of the *Auto Transit v. Brady*, which is kind of the old golden rule. It had a four-pronged test to establish nexus, and this is what I used in the State of Washington. And I basically learned it has pretty much been negated. The first rule—and you have to pass all four. The first rule is substantial nexus, and that is where most people argue. How many times does it take to visit to establish substantial nexus?

The second one is fair relationship. And I basically showed the budget in the State of Washington and where they spend their money—schools, human services, this sort of stuff—and showed that I spent no money whatsoever in the State of Washington, okay? But that particular prong has kind of been pushed aside by the courts. You cannot win on that anymore.

I argued fair apportionment, which meant I explained what percentage of my taxes were going to the State of Washington and how did that compare to the percent of my sales, the percent of my assets, the percent of employees in those various states. Very clear that Washington was way out of line. Once again, that has no meaning in the law today. Everyone ignores that issue.

The fourth one is non-discrimination, which means you cannot discriminate against interstate commerce. That is a complete waste of time to argue that one today.

So essentially what you have is lower courts, you know, State revenue services, lower courts in the states, are ignoring what little law was set by the Supreme Court. They are establishing their own laws, and it is a snowball effect. Every time a court puts some aggressive, you know, determination out there, it sets a precedent that everyone uses, and then they move it another step. And then eventually you reach the point where we are today. When one of my suppliers learned I was coming, they sent me this document from the State of Ohio. There are several states today that all they require to establish nexus is that you have sales in their state.

So what I can tell you is this is a very serious problem for companies like mine, and I would really appreciate your help. You need to put an end to this, and it is Congress' job.

[The prepared statement of Mr. Vegas follows:]

Statement of Pete Vegas
Founder & CEO, Sage V Foods

Before the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Hearing on H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

February 26, 2014

Members of the Subcommittee; my name is Pete Vegas and I thank you for allowing me to speak before you today. I am the founder and owner of Sage V Foods. Sage V Foods is primarily a manufacturer of rice based food ingredients. Our sales are about $100,000,000 per year. I provide good jobs and health insurance to over 200 people and have invested over $65,000,000 in new plant and equipment in the last seven years. Our customers are primarily large food companies. We do not sell any products directly to consumers. We are a LLC, so for tax purposes our profits flow through to me personally. In addition to federal Taxes, I pay state taxes in the State of California where I currently reside, as well as taxes in Arkansas, Texas, and Louisiana. I have no issue with paying tax to any of those states as I have assets and employees in those states that generate income for my company or me personally and my company uses the services of those states.

I recently had a very nasty and grossly unfair encounter with the Revenue Department of the State of Washington. This situation forced me to learn what a serious problem our country is facing in regards to unfair taxation of interstate commerce by many states. Specifically, some states are now unfairly collecting the tax revenue they need from companies located entirely outside of their state; companies that do not use services of the state. Very few small companies have yet to learn of this problem, but they soon will as the problem is quickly spreading. Federal statutes do not prevent the states from generating all of their tax revenue from residents and companies located outside of the state (though I think the U.S. Constitution does). Imagine how popular you would be as a politician if you could raise revenue to provide protections and benefits to your constituents without requiring your constituents pay additional taxes. Taxing non voters from outside your state is a much simpler solution to state budget problems than raising taxes paid by voters or cutting costs. More and more states are taking advantage of this opportunity. (Attached is a recent article that describes problems that other companies have faced.)

In my particular "run in" with the State of Washington, Sage V Foods was selling rice flour delivered in bulk railcars to a Con Agra owned facility in Pasco, Washington. The Con Agra facility blended rice flour with other ingredients to make a coating blend that was packaged and shipped to its Lamb Weston facilities and subsequently used to coat fried French fry potatoes to be shipped to a major hamburger chain. We had other small customers in the State of Washington, but over 90% of our business was the sale of bulk rice flour to Con Agra in Pasco, Washington. I estimate that less than 6% of my product utilized by Con Agra was actually sold to consumers in the State of Washington.

In 2010 one of our trucks carrying rice flour to a small customer in Washington was stopped at a weigh station and our name was collected by the Washington Department of Revenue. A few months later my controller received and answered a questionnaire from the State. We answered "no" to all questions, including "has your company warranted its products or services," "has your company maintained an office or other facility in Washington", "have you leased equipment for your own use in Washington", etc. But in response to the question "how many visits per year", my controller knew that 0 was not accurate, so she answered 1. In later phone calls with the Washington Revenue Department, we explained that we had visited only once in the 7 year period being audited. That clarification had no impact and we were issued a bill for $180,266.95 for back taxes, penalties, and interest; and then forced to continue paying taxes at the rate of about $20,000 per year. We paid $217,434.76 before I stopped paying. It is important to note that the State of Washington did not charge me income taxes; they charged Washington's substitute for an income tax, its Business and Occupation Tax, which is a tax based on my company's gross sales into the state. It is also important to note that unlike the income taxes that I pay in Arkansas, the Washington tax is not a direct offset to my California taxes, and it is payable whether my company earns a profit or not.

From a practical standpoint, there is no way for a company of our size to understand every oddball tax law in the 50 states of this country. I did not know at the time whether this practice of taxing entities that conduct all their activities outside of the taxing state was legal. Every business man that heard of my case was shocked that the State of Washington could charge my company taxes simply because I visited a customer in the State.

First Appeal.

I hired an attorney and appealed my case. My first appeal in September of 2011 was before a Judge employed by the Department of Revenue. It was immediately clear that our arguments were falling on deaf ears. Judge Okimoto explained that there was plenty of legal precedence in Washington to establish that merely visiting a customer in the state was enough to establish nexus. He said there was no bright line that established how many visits within a certain period of time established nexus. When I asked him what he thought, he answered with certainty that in his opinion one visit to the state (not one visit per year) was enough to establish nexus. We lost the appeal, and were forced to make immediate payment of the tax and penalties assessed.

Second Appeal.

I spoke with several attorneys in the State. They all agreed that my situation was grossly unfair, but they all stated that the Washington Dept. of Revenue was known to be grossly unfair and that I was certain to lose. They warned me that the Dept. of Revenue would fight to the bitter end and my costs of defense would far exceed my winnings. They stated that it would be a waste of money to hire an attorney and continue the fight. Because I am bull headed and often choose principal above money, I chose to defend myself and appeal my case before the Board of Tax Appeals and a panel of three judges. I studied the Constitution, Supreme Court rulings, and most of the precedent setting cases in other states and in the State of Washington. The "golden rule" in this area of law seems to be the Supreme Court case of "Complete Auto Transit v Brady in 1977". This case established a four prong test for constitutionality of a tax under the Commerce Clause. For a tax on an out of state company to be legal, all four prongs of the test must be satisfied. I argued that Sage did not meet the following 3 prongs of the four part test.

<u>Substantial Nexus. An activity with substantial nexus in the Taxing State</u>. I explained that I had only visited my customer one time in the 7 year period and that I made no effort to sell my products in the meeting. I explained that my sale had been made to the burger chain that used the French Fries (headquartered in another state) and my company was the named supplier in the spec sheet. Con Agra was essentially required to buy my product and so I did not need to sell them during my visit.

<u>Fair relationship. Is fairly related to services provided by the State</u>. I presented Washington's spending budget (Human Services, Public Schools, Higher Education, Transportation, Govt. Operations, Natural Resouces, Debt Service, etc) and I explained that Sage used absolutely no funds from the State of Washington. Our product was delivered via a railroad track owned by the Union Pacific Company and Con Agra. We did not even use Washington highways.

<u>Fair Apportionment. Is fairly apportioned</u>. I presented a chart that showed the percent of my company's assets, employees, and sales in the various states where I pay taxes (California, Arkansas, Texas, and now Washington). I then compared that to the percent of taxes charged by each state and demonstrated very clearly that the amount of taxes paid to the state of Washington was way out of line. I also demonstrated that the Business and Occupation tax charged by the State of Washington amounted to a 16% income tax and was higher than any income tax charged by any other State in the US.

I won a unanimous decision before the Board of Tax Appeals. They agreed that my one visit to Con Agra, which did not impact my sales to Con Agra, was not enough to establish Nexus. They did not rule on my arguments about Fair Relationship and Fair Apportionment. It should be noted that Complete Auto Transit and related rulings by the Supreme Court have been largely ignored by state courts, and have not been very successful in preventing flimsy nexus determinations in many years, maybe ever.

Third Appeal.

The Dept. of Revenue appealed to the Superior Court of Washington for Thurston County. Once again, I spoke with several attorneys in the State. They were very impressed and surprised that I won my appeal, but all advised me that the Dept. of Revenue would continue to appeal until a court turned down their case. My attorneys' fees would far exceed my recovery of funds. I tried to defend myself, but the Judge ruled that it was not legal to represent myself at this level in the Washington Court system. I found an attorney that was very interested in my case and offered to defend me at a reduced rate.

The Dept. of Revenue continued to argue that my one visit to the state constituted nexus, but this time they tried a new tack and focused on the fact that I used leased rail cars to deliver my flour to Washington and therefore claimed that I had leased assets in the State.

Our attorney argued that the State of Washington's own law is that to establish nexus "the activities in the state must be significantly associated with a person's ability to establish or maintain a market for its product in the state". Our product could have been delivered in many ways (Con Agra-owned rail cars, Union Pacific-owned rail cars, or trucks.). Our leased cars were not associated with our ability to establish or maintain a market and neither was my one visit to the state.

The judge ruled in our favor. After this ruling, instead of facing another appeal, Sage settled the case and recovered much of our taxes and penalties paid. Our funds were finally returned in Aug of 2013, three years after this ordeal started.

We won in principal, but it is very doubtful that the winnings covered the time and money we put into the case.

Conclusion.

The "Commerce Clause" of the US Constitution is found in Article 1, Section 8, Clause 3, and simply states "that Congress shall have the power to regulate commerce with foreign nations, and among the several states, and with the Indian Tribes".

Congress has not done a comprehensive enough job to regulate commerce among the several states and so this job has been taken up by state and local revenue departments and state courts. The Supreme Court has not addressed the issue of business activity tax nexus since it touched on the matter in the Quill case in 1992. It is unlikely that it will again, since the Constitution clearly makes it the responsibility of Congress. So recent rulings have come from lower state courts in those jurisdictions that are looking to take advantage of the situation. The last time the Supreme Court visited this issue, in the Quill case, they required a physical presence to establish nexus to impose a tax obligation on a nonresident company. The basis of this ruling has essentially been ignored by several state courts, as has the four prong test set forth in the Supreme Court case of "Complete Auto Transit v Brady in 1977".

So we now have a situation where the State of Washington expects Sage V Foods to pay Washington taxes simply because we have customers in the state. But it does not expect Washington based manufacturing companies that ship their products out of state to pay the same type of Washington taxes, despite the fact that those companies have substantial assets and employees in the state and use the services of the state. The State of Washington does not charge its residents any income taxes. The State of Washington does not charge its residents income taxes to send their kids to public schools and because of that they expect Pete Vegas, a resident of California, to pay for Washington public schools.

This situation is getting out of Control. Congress needs to set things right.

Mr. BACHUS. Thank you. Thank you. And we will come back with some questions hopefully.

Mr. Simmons?

TESTIMONY OF TONY SIMMONS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, McILHENNY COMPANY, AVERY ISLAND, LA

Mr. SIMMONS. Good afternoon, and thank you. McIlhenny Company currently has 240 employees, most of whom are located at Avery Island, Louisiana.

TABASCO is sold in over 166 countries and bottled in 22 languages and dialects. We make every bottle of TABASCO at Avery Island, and you will find our product in almost, if not every, grocery store in America. In addition, we also sell a large percentage of our product to the food service industry where it is used by chefs in the kitchen and as a condiment on tables.

Although our only manufacturing plan is in Louisiana, we currently pay state income and/or franchise tax in 13 additional states. We are subject to those taxes because we have employees and/or tangible personal property in those states which meets the physical presence standard in establishing nexus. Additionally, we pay income or other forms of business activity tax in seven additional states, thus a total of 21 states including our home state of Louisiana.

I am here today because state and local taxing authorities are increasingly and often retroactively expanding the reach of their business activity taxes using an expansive definition of "substantial nexus." I will give you three examples. My goal is to demonstrate why a bright line definition of what activity constitutes nexus is so important to companies who do business in multiple states.

First, last year, we responded to an inquiry from a city in Washington state for pertinent information going back to 2003. Not having employees or inventory physically located there, we were confident that we had no filing obligation. Following their review, the city argued that our use of an independent sales broker established nexus, and levied a business and occupation tax assessment of just over $32,000 in tax, penalty, and interest for the tax years from 2003 through 2008. This levy was based on our company sales of TABASCO products for the entire State of Washington.

In 2009, the city changed is rules to limit collections to those sales that occurred within its borders only. Under these revised rules, our sales are too small, and we owe no tax. The new rules, however, did not prevent the city from seeking payment for sales in the years before the change. As this case remains open today, I am not able to expand on it further. But suffice it to say that the costs of time, energy, and dollars dedicated to the process far outweigh the potential tax obligation, which is an underlying issue that surrounds this topic.

My second example is when we encountered the single business tax nexus standards of Michigan back in 2002. Noting that there were no McIlhenny company employees, inventories, or real property in the state, and that sales solicitations were performed by an independent sales broker in Michigan, we contested Michigan's attempt to apply its single business tax to our sales within the state. Despite extensive correspondence with the state and our numerous appeals on the merits of our case, an audit by the state resulted in a back tax liability in excess of $85,000. Again, the process of defending our position and subsequent monitoring and compliance adds to the overall administrative burden of complying with ever-changing tax interpretations.

Third and finally, our tax advisors have highlighted a developing situation where the State of Maine is declaring that promotion of a product within a grocery store by a third party representative located in their state creates nexus for the manufacturer and a filing obligation based on an analysis and interpretation the state has made of an old sales tax case.

These are just three examples. The task of monitoring, interpreting, and complying with unclear, unwritten, and constantly-changing state and local nexus interpretations places an undue burden on our limited resources, and brings uncertainty to our business planning and execution. We believe that adopting adopting the principles set forth in BATSA will allow businesses that do business in multiple states to have a clearly defined understanding of what constitutes nexus. We understand that modernization of the law brought about by BATSA may not provide an overall lower tax obligation for our company, but we do believe it will provide for more efficient compliance efforts and eliminate the uncertainty and excessive administration costs that currently exist.

[The prepared statement of Mr. Simmons follows:]

Tony Simmons

President and Chief Executive Officer – McIlhenny Company

February 26, 2014

Business Activity Tax Simplification Act of 2013
Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Statement of Tony Simmons

Good Afternoon, my name is Tony Simmons and I am President and CEO of McIlhenny Company located at Avery Island, Louisiana. McIlhenny Company is a 146-year old family owned and operated business whose most famous product is TABASCO® Brand Pepper Sauce. McIlhenny Company has 240 employees most of whom work at Avery Island. I am the 5th generation of my family to run the company started by my great great grandfather Edmund McIlhenny. In addition to running my family business I also serve as chairman of the S Corporation Association and as a director of America's Wetland Foundation.

TABASCO® is sold in over 166 countries and bottled in 22 languages and dialects. We make every bottle of TABASCO® at Avery Island and you will find our product in almost, if not every, grocery store in America. In addition to our sales through retailers we also sell a large percentage of our product to the food service industry where it is used by chefs in the kitchen, as well as served as a condiment on table tops in the front of the restaurant.

Although we only have one manufacturing plant, we currently pay state income and/or franchise tax in 13 states in addition to Louisiana. We are subject to these taxes because we have employees and/or tangible personal property in those states which meets the physical presence standard in establishing nexus, meaning it is easy for us to understand and comply. Additionally, we pay income or other forms of business activity tax in 7 additional states, thus a total of 21 states including our home state of Louisiana. Although we are not a large business we spend a significant amount of time and money to attempt to ensure we comply with all state regulations concerning the payment of state taxes. I want to make clear that we are not objecting to paying taxes to states where McIlhenny has employees or operations. Fully aware that location of McIlhenny people and property creates physical presence in certain states, the Company has dutifully fulfilled its obligation to pay state and local taxes in the appropriate jurisdictions. We understand our obligation to pay tax in areas where we locate in order to operate our business. Rather, I am here today to speak in support of HR 2992, the "Business Activity Tax Simplification Act" because we are seeing an increase in the number of cases where states are expanding their definition of substantial nexus to increase the number of nonresident companies subject to state income tax. They are doing this by applying a concept called "economic nexus," which argues that a state should be permitted to tax a non-resident company with not physical presence in the jurisdiction simply because that company has customers in the state. I will give you three examples McIlhenny Company has faced over the last several years and which I think will demonstrate to you why a bright line definition of what activity constitutes nexus is so important to companies that do business in multiple states. I will show you first, an example of how a municipality in Washington State imposed a Business and Occupation tax on our company, resulting in a demand for back taxes, penalties & interest 6 to 10 years after the fact; second, an over reach by Michigan which caused the state to demand we pay income tax in Michigan; and finally, a proposal by the state of Maine asserting that a company like McIlhenny would have nexus in the state if we attempt to promote the product directly to the consumer by doing in store product demonstrations or even price reductions.

I will start with the case of a city in Washington State.

Last year, we responded to an inquiry from a city in Washington. As a matter of everyday business, in addition to monitoring tax database services and consulting with our tax advisors on these matters, McIlhenny Company also receives and responds to questionnaires from various tax authorities across the country. Our internal accounting group, with assistance of our CPA firm, completed a questionnaire submitted by this municipality, as always, accurately disclosing the information requested. Not having employees or inventory physically located in the city, we were confident that we had no filing obligation. Upon review, however, the city claimed that our utilization of an independent sales broker with a branch office in the city established nexus in the jurisdiction and established a filing obligation. Here it is important to note that under current year rules, we were notified that nexus was established due to the broker's address, however, our business activity with the jurisdiction fell below the de minimis standards for a tax obligation. Along with this notification, however, came a request from the auditor for pertinent information going back to 2003. Following their review of the historical data, the city levied a Business & Occupation (B&O) tax assessment of just over $32,000 in tax, penalties, and interest reaching back to the tax years 2003 thru 2008. This levy was based on a rule that provided for a tax basis of TABASCO® products sales in what amounted to essentially the entire state of Washington.

In our work on this case, we learned that the expanded basis rule within the B&O tax calculation had been vigorously challenged by businesses, and subsequently revised in 2009 to limit the basis to the borders of the taxing authority jurisdiction, in this case, the city. We struggled with the concept of a tax authority reverting back to a prior law, which at some point in time supported a tax assessment, although current law had been improved to eliminate the expanded reach. As this case remains open today, I am not able to expand on it further.

However, suffice it to say that the costs of time, energy, and dollars dedicated to this process outweigh the tax obligation; an underlying issue surrounding this topic.

Going back a few years to 2002, among our initial exposures to the difficulty in reconciling an individual state definition of nexus to PL 86-272 standards, we encountered the Single Business Tax Nexus standards of Michigan. Noting that there were no McIlhenny employees, inventories, or real property in the State, and that sales solicitations were performed by an independent sales broker in Michigan, we contested Michigan's long reach across state lines. Despite our extensive correspondence with the State and our numerous appeals on the merits of our case, an audit by the State resulted in a back tax liability in excess of $85,000. Several years later in 2007 the tax was repealed and replaced by the Michigan Business Tax (MBT) and eventually the corporate income tax for C corporations and individual liability for S corporation shareholders. The nexus determination, however, also generated an ongoing annual obligation of $50,000 on average over the remaining years under MBT and more currently an annual obligation of $25,000 for the company's shareholders. Again, the process of defending our position, and subsequent monitoring and compliance added unfairly to the overall burden while it was in effect.

Finally, our tax advisors have recently brought to our attention a developing situation where the State of Maine is declaring that promotion of a product within a grocery store by a third-party representative located in their state creates nexus and a filing obligation for the manufacturer based on the state analysis and interpretation of an old sales tax case. Keeping in mind that our sales broker arrangement in Maine is consistent with our business practice of using independent entities to solicit sales, the delivery of the goods originated from a location outside Maine, and the TABASCO® goods are in reality the property of the retailer, we are uncertain on how Maine could convey presence to an out-of-state entity in this instance for income tax purposes. No doubt we will continue to monitor this interpretation as it could possibly have a direct impact on our business.

As I noted in my opening remarks, with its unique flavor and ability to enhance the flavor of food and beverages, TABASCO® Brand Pepper Sauce has gathered a tremendous following of users, providing for sales opportunities in all fifty states. With the Company's relatively small footprint at Avery Island, Louisiana, we have been able to fulfill this demand through the use of various independent business entities that provide expertise in sales, marketing, physical logistics and other supply chain activities, many of which operate on a local or regional basis in various states around the country.

From these examples, I believe you can appreciate the level of complexity our Company is now required to embrace as we attempt to understand the differences in nexus definitions among the states. As you might imagine, the environment in the consumer goods industry, in general, and the hot and spicy food market category, in particular, is quite competitive. Monitoring, interpreting, and complying with, unclear and constantly changing individual state and local nexus regulations places an undue burden on our limited resources, and brings uncertainty to our business planning and execution.

It is our contention that adopting the principles set forth in BATSA will provide, our TABASCO® business and other businesses similar to ours with clarity and certainty relating to our state income tax obligations. We clearly understand that modernization of the law brought about through BATSA may not provide a lower overall tax obligation for our Company, but we do believe it will provide for more efficient application of our compliance efforts, and eliminate the uncertainty from the moving targets associated with nexus establishment. This enables us to focus our energies and resources on growing our business on a level playing field …

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Mr. BACHUS. Thank you. Thank you.

Mr. Henchman?

TESTIMONY OF JOSEPH HENCHMAN, VICE PRESIDENT OF LEGAL & STATE PROJECTS, TAX FOUNDATION, WASHINGTON, DC

Mr. HENCHMAN. Mr. Chairman, Mr. Ranking Member, Mr. Chairman, thank you for the opportunity to appear before you today on the subject of the scope of state business activity taxation. And I am one of those people who carries around the Constitution with him. I am a lawyer. And in there is your power to regulate interstate commerce. The reason it is in there is because before the Constitution, the states, left to their own devices, just about wrecked the national economy. Port states put taxes on goods going into interior states. Interior states taxed the port states, and everyone tried to exempt their own residents and put all their taxes on interstate commerce. That crisis a big reason why they all gathered in Philadelphia and gave you the power to limit the ability of states to tax entities with no physical presence in the state.

The physical presence rule for business taxation is not only good constitutional law, it is good tax policy. Now, I am not an economist, but I am surrounded by them at my office. And they talk about the benefit principle, the idea that people and businesses should pay taxes in the places where they benefit from government services. For businesses, that is where they have property and employees. States should pay for services by taxing the residents who live and work in the state and benefit from those services.

Congress has acted on this before. In 1959, Congress enacted P.L. 86272, and was going to do more, but the states said if Congress would just stay away, they as the states would solve it, and the thing would get better. They have not. I wish I could say what happened to Mr. Vegas was an isolated example, but in many states, it is official policy. I could review lots, but in the interest of time I brought five pulled from the excellent Annual Survey of Tax Officials done by Bloomberg BNA. And with the Chairman's indulgence, I would like to draw attention to some charts that I brought.

The first chart, which is up already, is the question of how long nexus lasts in a state if the business stops the activity. The gray states say it is just for the taxes measurement period, so if the tax is just for a quarter, the nexus only lasts for a quarter. The green states apply nexus for the full year. Washington state adds on a little bit more, as Mr. Vegas said, beyond that year. A couple of the states, the black ones on this chart, they declined to answer the question, which is certainly not helpful. California and Georgia said it depends, which is also not helpful, and in Indiana, apparently nexus lasts forever. Next chart.

This chart is whether you have nexus because you have a website and you pay some third party to host the website, and that third party has a server in the state. You all have websites. Do you know where it is hosted, where the server is? Well, if you are a company, 14 states say that is enough for you to have nexus in that state, and 18 states declined to answer the question. Next chart.

This chart is a state will find nexus if you send a catalog into the state. No people, no sales in the state, just sending a catalog. This is pretty open and shut in the case law, and most states are good. Those are the blue states. But seven states, the red ones, say that is nexus, and two more say it depends. Next chart.

This chart involves having a non-solicitation back office employee telecommuting from the state. Now, under BATSA and under the physical presence rule, there should be a finding of nexus in this case, so I am not too worried about the yeses. Those are the reds, those are the noes, those are the blues. I am not worried about the noes because just because a state can tax, it does not mean they have to.

What I am worried about are the eight states, the black ones on there, that declined to answer this pretty basic question. That is eight states where taxpayers cannot get the answers from their officials to rely on for their business activity. Next chart.

This chart shows the states that define nexus if you attend a trade show in red. Now, this is attend a trade show. It is not exhibiting or selling stuff. Every state finds nexus if you go and have a booth at a trade show and sells stuff. This is merely attending a trade show will find you nexus in 10 states. Five more states say it depends, and five more decline to answer the question.

This is all basic stuff. The last time we had this hearing, the states talked about physical presence would harm their revenue, even though these taxes are a tiny portion of their budgets. And they are cutting them anyway for in-state companies through single sales factor and tax incentive deals. They talked about how it encouraged tax evasion, even though this bill does not change one thing about the ability of states to go after tax evaders. They talked about state sovereignty even though stuff like this is precisely why Congress has the power to regulate state taxation of interstate commerce.

I hope today we get some answers. If states are handling this and Congress does not need to get involved, why is basic guidance about nexus all a mess over there? The truth is states do not want to fix this problem. Like before the Constitution, they are happy to substitute their parochial interests for the national economic interests. They are doing harm, and the court cases have gone both ways, so it is time to be on time for there to be a modest national framework answering this simple and key question: how far does state tax authority over inter-state business extend? If Congress does not answer that question, no one will. Thank you.

[The prepared statement of Mr. Henchman follows:]

Written Submission of
Joseph Henchman
Vice President, Legal & State Projects
Tax Foundation

Hearing on
H.R. 2992,
The Business Activity Tax Simplification Act of 2013

Before the Committee on the Judiciary, Subcommittee on
Regulatory Reform, Commercial and Antitrust Law

February 26, 2014

TAX FOUNDATION Since 1937

National Press Building
529 14th Street, N.W., Suite 420
Washington, DC 20045
TEL 202.464.6200
www.TaxFoundation.org

The Proper Role of Congress in State Taxation: Ensuring the Interstate Reach of State Taxes Does Not Harm the National Economy

Joseph Henchman
Vice President, Legal & State Projects, Tax Foundation

Hearing on H.R. 2992, The Business Activity Tax Simplification Act of 2013
Before the Committee on the Judiciary, Subcommittee on Regulatory Reform, Commercial & Antitrust Law

February 26, 2014

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

I appreciate the opportunity to submit this statement on Congress's role in the debate over state sales taxation of online purchases. In the 77 years since our founding in 1937, the Tax Foundation has monitored tax policy trends at the federal and state levels, and our data and research is heavily relied upon by policymakers, the media, and the general public. Our analysis is guided by the idea that taxes should be as simple, neutral, transparent, and stable as possible, and as a 501(c)(3) non-profit, non-partisan organization, we take no position on any pending legislation.

We hope that the material we provide will be helpful in the Committee's consideration of the issue.

Executive Summary

- After the bitter experience of the Articles of Confederation, the Constitution empowered Congress with the responsibility to rein in state tax overreaching when it threatened to do harm to the national economy. Consequently, states were not permitted to tax items in interstate commerce at all until approximately the 1950s. Since then, as formally adopted by the U.S. Supreme Court in the *Complete Auto* decision (1977), states may tax interstate commerce so long as the tax is non-discriminatory, fairly apportioned, related to services, and applies only to businesses with substantial presence (nexus).
- In 1959, Congress enacted Public Law 86-272, which excludes from nexus the solicitation of orders of tangible personal property by in-state personnel where the orders are approved from out-of-state and shipped from out-of-state. The law overruled the U.S. Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). States have sought to narrow the definition of "solicitation" in P.L. 86-272 and prevent further federal action defining a uniform scope of state nexus.
- The U.S. Supreme Court has held that substantial nexus in the context of sales taxes means

physical presence in the jurisdiction but, aside from overruled *Northwestern Cement*, has not further ruled one way or the other in the context of business activity taxes. Some state courts have adopted physical presence or economic nexus and state revenue departments issue a wide variety of guidelines on what constitutes nexus-causing activity. For example, 14 states now find nexus if a company contracts website hosting services with a third party who owns a server in the state. (18 states declined to answer whether such activity would create nexus.) When asked how long nexus lasts once the nexus-causing activity has ceased, 9 states say immediately, 30 states say at the end of the year, 1 state says at the end of the *following* year, 1 state says indefinitely, 2 states said "depends," and 5 states declined to answer.

- State have made no progress on uniform rules about nexus-causing activity, and in many cases, decline to even answer inquiries about whether a particular activity will or will not create nexus. When asked if attending a trade show creates nexus, 10 states said yes, 28 states said no, 5 state declined to answer, and 5 states said that it "depends." When asked if having one non-sales employee telecommuting from the state creates nexus, 33 states said yes, 7 states said no, and 8 states declined to answer. When asked if a catalog mailing to residents of a state creates nexus, despite the similarity to the scenario of P.L. 86-272, 7 states said yes and 2 states said "it depends."
- Only Congress can bring sanity to this patchwork of overly aggressive rules that is currently doing harm to our national economy. Clarifying that substantial nexus for business activity taxes must be linked to the physical presence of solicitation activity in the state is in line with international taxation concepts and with the "benefit principle" idea of paying taxes in the jurisdiction where you get the benefits of government services. The revenue impact to states will be minimal, and generally states are adopting "single sales factor" rules that reduce their reliance on corporate income tax by in-state taxpayers anyway. It would also not change states' ability to combat illegal or possibly illegal tax planning activities.

The Constitution Empowers Congress to Limit State Tax Power When It Seeks to Shift Tax Burdens to Non-Residents or Do Harm the National Economy

What you have before you is not a new issue. Absent congressional or judicial checks, states have an incentive to shift tax burdens from physically present individuals and businesses, to those who are beyond their borders. Indeed, it was the states' unchecked behavior in this regard that led to the Constitutional Convention in the first place. Under the Articles of Confederation, states with ports taxed commerce bound for interior states, tariff wars proliferated, and the national economy was imperiled. As Justice Johnson described in 1824, these actions were "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]

And so the Constitution was adopted, and through that document, the Congress was granted the power to restrain states from enacting laws that harm the national economy by discriminating

[1] *See, e.g., Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 224 (1824) (Johnson, J., concurring).

against interstate commerce.[2] James Madison noted that these powers would check the "clamors of impatient avidity for immediate and immoderate gain" that drive state legislation discriminating against non-residents.[3] Justice Story later praised the "wisdom and policy in restraining the states themselves from the exercise of [taxation] injuriously to the interests of each other."[4]

So strong was this concern that the rule for a century and a half was that states could not tax interstate commerce at all.[5] This eroded in the 1950s and 1960s as it was recognized that those engaged in interstate commerce do enjoy benefits in states where they are present, so it is not unfair to have them support those services with taxes. The complete ban on state taxation of interstate commerce was abandoned in 1977, replaced by a recognition that resident businesses engaged in interstate commerce should pay for the fair share of the state services they consume. In *Complete Auto Transit, Inc. v. Brady*, the U.S. Supreme Court held that states may tax interstate commerce if the tax meets a four part test:[6]

- **nexus**, *a sufficient connection between the state and the taxpayer;*
- **fair apportionment**, *the state cannot tax beyond its fair share of the taxpayer's income;*
- **nondiscrimination**, *the state must not burden out-of-state taxpayers while exempting in-state taxpayers;*
- **fairly related**, *the tax must be fairly related to services provided to the taxpayer.*

Before and since *Complete Auto*, the courts have routinely exercised this power to restrain state tax infringements on interstate commerce, and these decisions are one of the more non-controversial aspects of constitutional law. Congress has also been active in this area, legislating limits on state tax power where states are incapable of achieving a simplified, uniform system that restrain each state from claiming more than its fair share of taxes on interstate commerce. These have included prohibiting state taxes on food stamps, Federal Reserve banks, interstate airline and bus travel, satellite services, and nonresident members of the military and nonresident members of Congress. Congress has also banned discriminatory state taxes on federal employees, interstate electricity transmission, and interstate railroads.[7]

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[2] *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).

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

[4] 1 STORY CONST § 497.

[5] *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.").

[6] 430 U.S. 274 (1977).

[7] Examples include 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 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

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. Chief among these has been efforts to expand the definition of "substantial nexus" in business taxation, sales taxation, and income taxation to activity beyond the state's borders. Some of these aggressive practices have been upheld by state supreme courts, some have been struck down; in all cases, the U.S. Supreme Court has declined to hear appeals.

At the same time, states are giving in-state business exemptions, waivers, and credits from their corporate income tax. By our most recent count, all but two states (Alaska & Michigan) offers 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. Many states have adopted "single sales factor" apportionment, under which they do not consider in-state property or payroll when apportioning taxes owed by in-state corporations. While states can certainly choose to not tax their residents, these actions (along with the shift of business activity away from C-corporations to S-corporations and LLCs) have led to a long-term decline in the state corporate income tax.[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

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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).

[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/570.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;

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]

FIGURE 1: 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
1979	9.7%	4.9%
1984	7.9%	3.9%
1989	8.4%	4.1%
1994	6.9%	3.1%
1999	6.2%	2.7%
2004	5.1%	1.9%
2009	6.1%	N/A

Source: US Census; Tax Foundation.

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.

Nexus Based on Physical Presence

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.

In 2006, Mr. Michael Mundaca, later 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

[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.").

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 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.

Given the inch by *Complete Auto*, 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."[13]

Examples of State Exploitation of Unclear Nexus Rules

The charts on the following pages, taken from the excellent annual *Survey of State Tax Departments* by Bloomberg BNA, illustrate the lack of clarity that states provide on what activity constitutes nexus. We could offer many absurd examples of the status quo, but offer just five here.

Bills like BATSA would provide the uniformity and clarity that the states are incapable of providing, and would restrain state taxation to its proper scope.

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[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.batsa.org/mundaca.pdf.

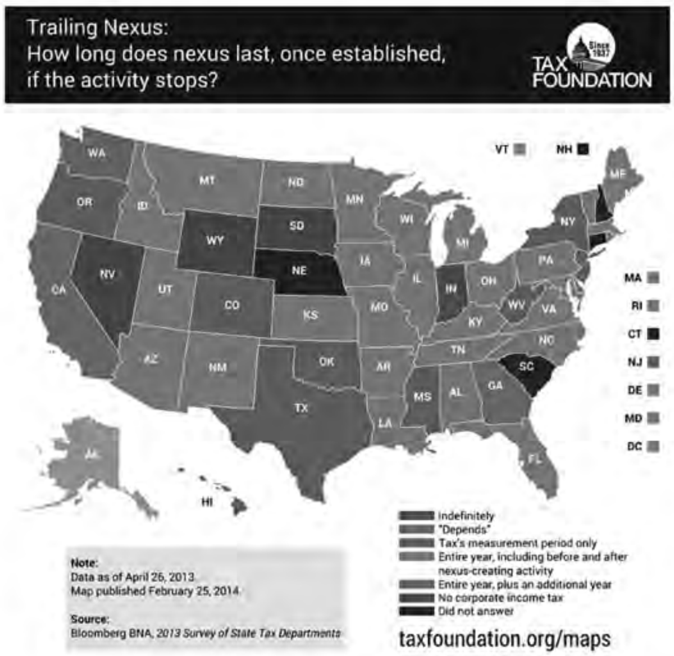
[11] States with aggressive sales tax statutes are Arkansas (just enacted this month), Colorado, Illinois, New York, North Carolina, and Rhode Island. All have either failed to collect any revenue and/or are subject to ongoing litigation.

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

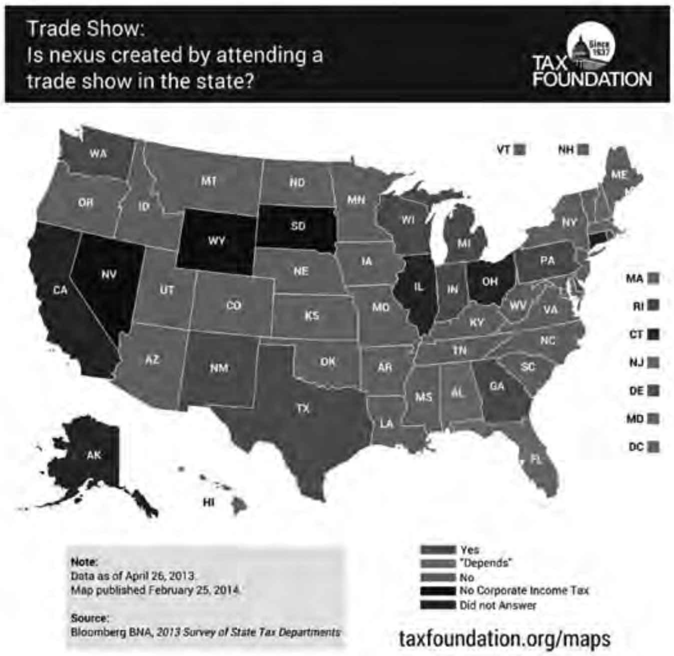
How Long Does Nexus Last?

When asked how long nexus lasts once the nexus-causing activity has ceased, 9 states say immediately, 30 states say at the end of the year, 1 state says at the end of the *following* year, 1 state says indefinitely, 2 states said "depends," and 5 states declined to answer.



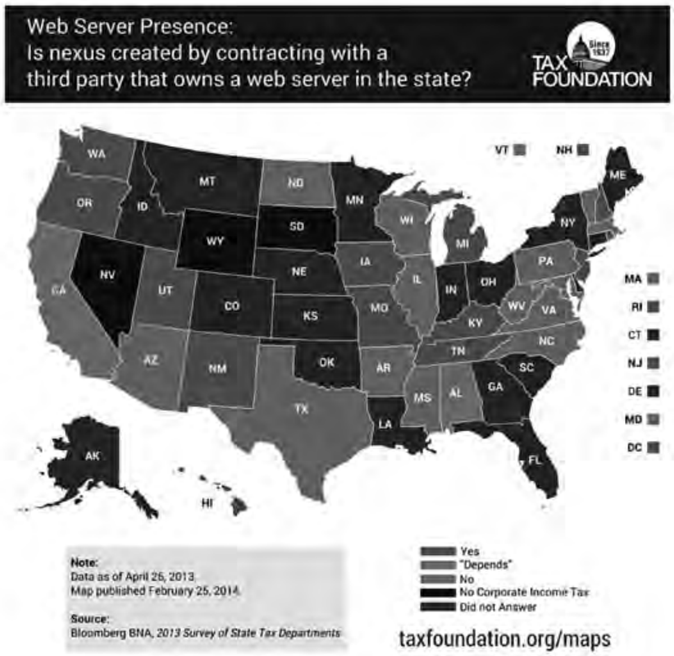
Attending a Trade Show

When asked if attending a trade show creates nexus, 10 states said yes, 28 states said no, 5 state declined to answer, and 5 states said that it "depends."



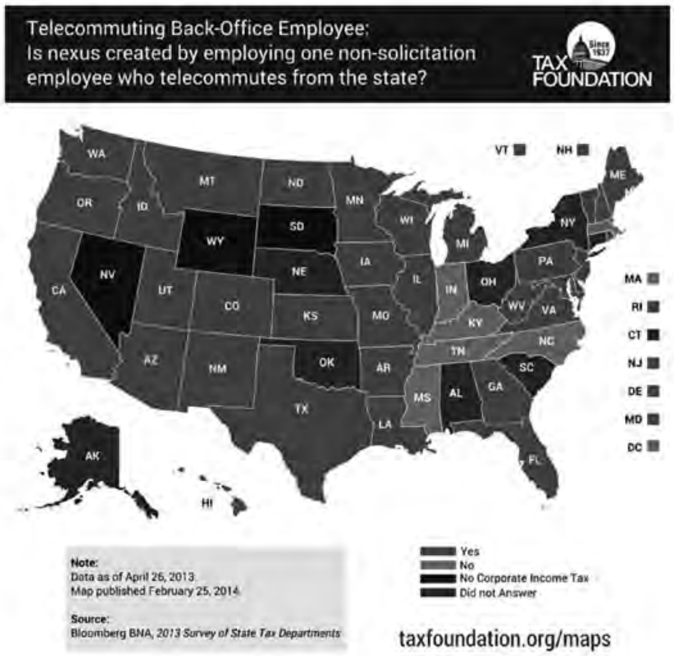
Presence of a Web Server

14 states now find nexus if a company contracts website hosting services with a third party who owns a server in the state. (18 states declined to answer whether such activity would create nexus.)



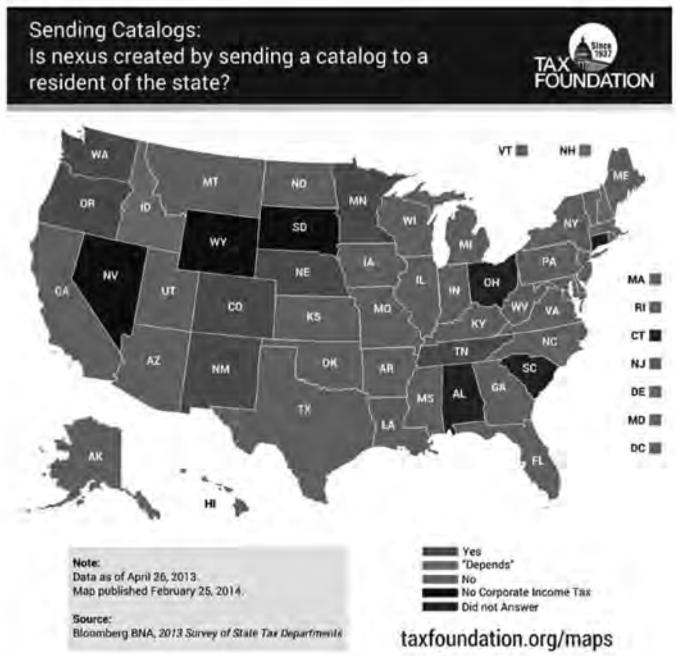
Telecommuting Back-Office Employees

When asked if having one non-sales employee telecommuting from the state creates nexus, 33 states said yes, 7 states said no, and 8 states declined to answer.



Catalog Mailing

When asked if a catalog mailing to residents of a state creates nexus, despite the similarity to the scenario of P.L. 86-272, 7 states said yes and 2 states said "it depends."



Conclusion

Businesses throughout our nation's history have plied their trade across state lines. Today, with new technologies, even the smallest businesses can sell their products and services in all fifty states through the Internet and through the mail. We at the Tax Foundation track the numerous rates, bases, and exemptions that litter our state sales tax codes. Frequent and ambiguous alterations of tax codes and the confusion they cause are a key source of the growing tax compliance burden. We have several staffers as well as computer-based and publication subscriptions dedicated to being up to date and accurate on the frequent changes, but even we have trouble doing it. It would be extremely difficult for those in business to do business, not conduct tax policy research.

We now live in a world of iPods, telecommuting, and Amazon.com. It is a testament to the Framers that their warnings about states' incentives to hinder the national economy remain true today. Some may argue that faster roads and powerful computers mean that states should now be able to tax everything everywhere. While some constitutional principles surely must be revisited to be applied to new circumstances, the idea that parochial state interests should not be permitted to burden interstate commerce remains a timeless principle regardless of how sophisticated technology may become.

ABOUT THE TAX FOUNDATION

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our principled research, insightful analysis, and engaged experts have informed smarter tax policy at the federal, state, and local levels.

ABOUT THE CENTER FOR LEGAL REFORM AT THE TAX FOUNDATION

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

Mr. BACHUS. Mr. Quam. Is that right? Did I get it right?
Mr. QUAM. Quam, yes.
Mr. BACHUS. Quam, I got it right.
Mr. QUAM. Yes.

TESTIMONY OF DAVID QUAM, DEPUTY DIRECTOR, NATIONAL GOVERNORS ASSOCIATION, WASHINGTON, DC

Mr. QUAM. Thank you, Mr. Chairman. Thank you, Member Johnson. Chairman Goodlatte, good to see you, too.

Thank you for the opportunity to be here again. I actually pulled several of the letters and testimony from previous hearings, and I think four times I have appeared before this Committee on this particular issue. And it is an issue that keeps coming up, and I have sympathy for the stories that have been told. I think anybody would. Any governor would.

At the same time, it is a privilege to be here on behalf of the National Governors Association to say we have to oppose this bill. We have to oppose it because it does tread on state sovereignty. It does not solve the problem that is being articulated. And at the end of the day, it does do harm, and it does harm to states.

Now, this Congress has the ability under the commerce clause—I am not going to dispute that—to work on interstate commerce and solve those problems. It does not always mean, though, that the Congress has to act. But when it does and when it looks at state problems or state taxation, there are a couple of guidelines that we use to say when is it appropriate for Congress to get involved. And the first one is really do no harm. Do no harm to the states because, after all, we are talking about state tax laws. And a key premise for governors when it comes to state tax laws is that decisions regarding state revenue systems should be made in state capitals, not Washington, D.C.

Unfortunately, this bill, which is identical to a bill passed last Congress and scored by CBO, would take away about $2 billion in the first year in state revenues. The changes in nexus would not allow states to collect about $2 billion they collect today. Now, for the states that is meaningful because states, unlike the Federal Government, have to balance their budgets. And so, $2 billion out-of-states is $2 billion that either has to be cut or raised in taxes, both which can harm the recession or harm states' ability to recover from the recession that they are still dealing with.

The $2 billion in the first year is merely the starting point. What this bill does, because it provides rules of the road to allow for greater tax avoidance, means that states will actually lose more money in the out years, $2 billion in the first year, growing in years thereafter.

Now, let us say that we could actually make a bill where you do no harm. I think everybody would agree, and even states would agree with, be clearer. Tax laws should be clearer. It helps with state compliance. It helps states enforce their laws. It helps companies to comply with those laws.

Unfortunately, the bill before us and previous iterations is not clear. It claims to say that physical presence should be the law of the land, yet this is physical presence plus. You can actually be in the state for 15 days and do business. You can have multiple people in the state doing business for 15 days. You are not going to be liable under this bill. That is not physical presence. The loopholes and exceptions to the physical presence standard actually create more problems and are not clear for either states or businesses at the end of the day.

In addition, for the companies that are both here and some of the small companies that reside in your states, you are actually increasing the tax burden on them. Why is that? Because some of the larger businesses can use the loopholes of this bill to avoid state taxation. Those large companies that have the lawyers, that have the accountants, that can do the planning, that can shift the property ultimately can create a situation where they do not pay tax. There is nowhere income, according to the Congressional Research Service that looked at a similar version of this bill 5 or 6 years ago.

When you take those tax dollars out of a state from some of your larger taxpayers, you are increasing the burden on those who cannot do that type of tax planning in your own state. And that is some of the small- and medium-sized businesses that reside and are visibly present.

Finally, there has to be a respect for state sovereignty. The 10th Amendment did mean something, and at the end of the day, the ability to control revenue systems is a key tenant of federalism. What that ultimately is at the end of the day is a Federal tax cut, Federal corporate tax cut, using state tax dollars, changing this nexus standard, so actually taking $2 billion away from the states.

Now, I should mention that NGA actually participated through this Committee in talks over the course of several months with industry to try to find a clear bright line standard. We had discussions about the problems that were raised and how they could be addressed. States have actually posed a very clear standard, yet one that is economic presence. What I would argue is actually the law of the land. Businesses at the end of the day could not get past wanting a physical presence standard because that allows for the type of planning that they want to do.

We have no problem with clarity. We have actually had no problem with finding that bright line rule, but it needs to be done within the constitutional and context in which we find ourselves, and that is, for business income taxes, economic presence is the law of the land. And so, from there we start and we take a look at a bill like this and say on behalf of the National Governors Association, we must oppose this bill. Thank you.

[The prepared statement of Mr. Quam follows:]

Statement of

David Quam, Deputy Director, National Governors Association

Before the

House Subcommittee on Regulatory Reform, Commercial and Antitrust Law

H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

February 26, 2014

Chairman Bachus, Ranking Member Johnson and members of the Subcommittee, I am pleased to appear before the subcommittee on behalf of the National Governors Association (NGA) to communicate governors' strong opposition to H.R. 2992, the "Business Activity Tax Simplification Act of 2013."

For governors, the core principle Congress should adhere to regarding state taxation is simple: decisions about state revenue systems and state taxation should be made by elected officials in the states, not the federal government.

Governors believe federal action should favor the preservation of state sovereignty when legislating or regulating activity in the states. This is particularly true when it comes to actions that affect the ability of states to manage their revenue systems. The independent ability of states to develop and manage these systems is a basic tenet of our federal system. Therefore, the federal government should avoid legislation and regulations that would serve to preempt or prohibit, either directly or indirectly, sources of state revenues or state taxation methods that are otherwise constitutional.

Governors oppose H.R. 2992:

H.R. 2992, the "Business Activity Tax Simplification Act of 2013," like its predecessors in earlier Congresses, represents an unwarranted federal intrusion into state affairs that would allow companies to: avoid and evade state business activity taxes (BAT); increase the tax burden on small businesses and individuals; alter established constitutional standards for state taxation; and cost states billions in existing revenue.

H.R. 2992 violates core principles of federalism:

Governors oppose H.R. 2992 because it represents an unnecessary intrusion into the states' authority to govern.

U.S. courts have long recognized the authority of a state to structure its own tax system as a core element of state sovereignty. H.R. 2992 would interfere with this basic principle by altering the constitutional standard that governs when states may tax companies conducting business within their borders. Specifically, the bill would mandate the use of a *physical presence* standard for determining whether an entity can be taxed. This differs from *economic presence*, such as the "doing business" or "earning income" standards used by most states. As discussed below, this change would shrink state tax bases by relieving out-of-state businesses of BAT liability while allowing larger in-state companies to circumvent tax laws by legalizing questionable tax avoidance schemes. These outcomes would effectively constitute a federal corporate tax cut using state tax dollars – a decision that, fundamentally, should be left to state elected officials.

H.R. 2992 would encourage tax evasion and avoidance:

H.R. 2992 promotes avoidance of state taxation. At a time when the federal government is closing loopholes in the federal tax code, H.R. 2992 would subvert state tax systems by creating opportunities for companies to structure corporate affiliates and transactions to avoid paying state taxes.

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

If enacted, the physical presence nexus standard of H.R. 2992 would federally codify such tax practices and grant corporations with the means to restructure their businesses with a federal permission slip to aggressively avoid state taxation. Just last year the Senate Homeland Security and Government Affairs Committee examined the lengths to which corporations will go avoid taxation. Although the focus was on international taxation, the tax planning of companies like Apple, Google and Cisco are emblematic of the tax practices that could be employed by companies to avoid state taxation under a physical presence nexus standard. ("Google Joins Apple Avoiding Taxes With Stateless Income," Bloomberg, May 22, 2013.) A common thread among the strategies was the formation of entities in jurisdictions that do not tax certain activity, followed by a shift of income or property to the entity to avoid taxation.

H.R. 2992 would harm locally-owned and small businesses:

H.R. 2992 would favor large, multi-state corporations to the detriment of small businesses and individual taxpayers. By raising the jurisdictional standard for taxation, H.R. 2992 would effectively limit a state's business activity tax base to in-state companies. Out-of-state vendors could therefore compete for customers against in-state businesses with the potential advantage of iuequitable tax respousibilities.

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

H.R. 2992 would alter established constitutional standards:

H.R. 2992 would alter the existing coustitutional standard for taxatiou of business activity. As noted in previous testimony by Bruce Johnson, commissioner for the Utah State Tax Commission:

> "BATSA is often described as "codifyiug 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 beuefits derived from the state.[1] In the ouly 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

[1] [2] See *Complete Auto Transit v. Brady* 430 U.S. 274 (1977).

> 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), *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."

By mandating a physical presence standard for establishing nexus, H.R. 2992 would fundamentally rewrite the well-established constitutional standard for business activity taxes and call into question state business activity tax systems in every state.

H.R. 2992 would undermine state revenues:

H.R. 2992 represents a huge unfunded mandate that will result in the loss of billions of dollars for states. In 2011, the Congressional Budget Office estimated that identical legislation would cost states – in the form of forgone revenues – "about $2 billion in the first full year after enactment and at least that amount in subsequent years. " (Congressional Budget Office Cost Estimate, "H.R. 1439, Business Activity Tax Simplification Act of 2011," September 13, 2011)

This shift in revenue, while beneficial to businesses able to take advantage of the new standards, is harmful to states. Unlike the federal government, states are required to balance their budgets. Consequently, when federal action causes states to lose revenues, states must act to replace lost funds by either increasing taxes or cutting programs. The economic effects of such actions are pro-cyclical in that they can slow recovery as states are emerging from recession.

Mr. BACHUS. Thank you. You know, one thing I would say. The National Governors Association, you know, you are saying it harms the states, this $2 billion. But, you know, the two examples that I hear at this end of the table, you have harmed these businesses. If the State of Washington, if every state took that approach, you would put this man out of business, I would think. I mean, you heard the testimony about Maine. If a retailer has an advertisement or a third party advertising his product, I mean, that is pretty far-fetched.

I would think that, you know, 20 years ago states did not try to use this type of collection. I mean, I cannot imagine that they did. You know, Mr. Vegas visits a state one time, and, I mean, he is opened up to all that.

My main concern with this, and we talk about jobs, jobs, jobs. That is America's number one problem. You know, we talk about home ownership is the American Dream, but if you do not have a job, you are never going to own a home. You cannot provide for your children.

Small businesses have historically created 70 percent of the jobs in this country. They are not doing that anymore. Large businesses are getting bigger and bigger, because just as you said, they can afford the lawyers. They are either doing a lot of business in those states, or they have the lawyers to fight these things. A small business, I am not sure it could even get started today. A small business of 5, 10 employees, if seven generations ago they started shipping tabasco sauce and they ran into this, it would cost all their profits for 1 year in one isolated state.

I believe that is one reason this sort of thing, whether the states feel like they have a right or whatever, this sort of taxing regime is going to make it nearly impossible for a small business to be able to do business across state lines. I will let you respond to that.

Mr. QUAM. Well, Mr. Chairman, as I said, the facts as they have presented here today, I am very sympathetic. I think there is always a different side to that story and a different side to the case. And without the states actually being here to defend themselves and not knowing exactly all the different aspects of the states, I am not going to get into those specific——

Mr. BACHUS. Well, let us just take the example of Maine. He is not in Maine. He does not have employees in Maine or Michigan. He has an independent contractor. I mean, physical presence ought to be physical presence. I mean, we do have a constitutional right to not interfere with interstate commerce. And, I mean, my gosh. This has a chilling effect on that.

Mr. QUAM. The physical presence standard that is set up by this bill is actually moving backwards when it comes to sort of the——

Mr. BACHUS. And any——

Mr. QUAM. Rather than interstate commerce where the internet has made us borderless, where a small business actually can start out of the garage and do business in multiple states, rather than finding some of that clarity and find out every business who is earning customers in another state, is also, therefore, possibly taking customers away from those businesses——

Mr. BACHUS. Well, I will tell you. One thing this taxing policy may be doing, it may be driving companies to become basically internet companies, I mean, because if they do anything else, if they ship a product into a state, they run into this.

Let me ask you this. You know, we are considering giving the state the right to collect sales tax, out-of-state, and that is going to be a tremendous boon to the states. To me, that is where the emphasis ought to be for the states is pushing that. I mean, I am just——

Mr. QUAM. Marketplace fairness and passage of marketplace fairness is our number one priority.

Mr. BACHUS. Yes, and I think it should be. And I have been on your side of that issue for some time.

Mr. QUAM. Yes, sir.

Mr. BACHUS. Not everybody on this Committee is.

Mr. QUAM. We are working on it.

Mr. BACHUS. But these are, I mean, nightmare scenarios.

Mr. QUAM. Mr. Chairman, I am going to go back to what I said before. Marketplace fairness where states are simplifying their tax laws in order to recognize the 21st century borderless economy and to make sales taxes fair so you do not have winners or losers in business, the economic presence standard in business activity tax is similar. It is borderless. It is about you are doing business in another state and earning customers.

Now, again, I have sympathy for the two cases that were brought up here today. I do not know the factors and I do not know the state side. However, to take this one back to a physical presence standard, which is really a 1950's construct where you have to do business with a handshake versus today, and then support marketplace fairness, which is moving in the other direction. I think instead what we need to be doing is creating certainty and clarity and not picking winners and losers.

Mr. BACHUS. Well, and let me say this. You know, this is, I think, the Chairman's bill.

Mr. QUAM. Yes.

Mr. BACHUS. I believe in it. I am a strong supporter. But, you know, you are invited. I mean, you have an open door to come to our staff and say I think this is a problem.

Mr. QUAM. That is exactly why, and some Members of this Committee know this, why we did come up and we tried to talk about let us create certainty, but let us create certainty that also works for the states and matches the 21st century economy. Unfortunately, we did not get there. Certainty is not a problem that we have. We are willing to always have those discussions.

Mr. BACHUS. Thank you.

Mr. QUAM. But those two have to go together. Thank you.

Mr. BACHUS. Thank you. Mr. Johnson is recognized.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. BACHUS. The representative from Washington state showed up. [Laughter.]

Mr. JOHNSON. Just in time.

Mr. BACHUS. You would not believe what your state is doing. [Laughter.]

Mr. JOHNSON. Well, I will tell you, all states do not have a business activity tax, do they, Mr. Henchman?

Mr. HENCHMAN. Three states do not.

Mr. JOHNSON. Three states do not. And we would not want to force those states to adopt one, I do not think, at this time. So we want the states to have some freedom. Clearly the commerce clause gives the Federal Government——

Mr. HENCHMAN. Right, and this bill, like the bill you sponsored, the Mobile Workforce, in a similar way, they are floors. So states can be more generous in the protections they provide. They cannot have a tax if they choose, but so long as it does not go below what the Federal Government prescribes.

Mr. JOHNSON. Those that do have a business activity tax, though, it seems like there should be some uniformity in there so that there will not be 47 different schemes that have to be adhered to by today's modern business. That is just an untenable position to be in. But you would disagree with that, Mr. Quam?

Mr. QUAM. I would say the tenets of federalism allow us to have a system of 50 different state laws where state lawmakers get to make the choices and in this particular area of what it means for nexus. That being said, groups and states, including the Multistate Tax Commission, have come up with some uniformity under an economic presence standard that would be very clear that every state could use.

Unfortunately a lot of businesses have pushed back against that, have pushed back against efforts to try to find this clarity and this middle ground, something that does not do harm to states as far as existing revenues, but would create clarity. And so, it is very difficult to find that middle ground when you say, everybody is different, so one standard is going to preempt everybody, allow us to do tax planning to actually avoid taxation. It is going to cost states $2 billion from what they collect today, and that is a better solution than something that does not harm to states. The states have imparted that solution, and create some real clarity. But it is not going to present that opportunity for that type of tax avoidance.

So again, I think there is a ground here that has to be covered, but because of the 10th Amendment and federalism, have to tread very carefully when we are talking about state tax systems, because the ability to control those tax systems at the end of the day is a core of what state sovereignty means. And so, when you move into that realm, we have got to be very careful that we do not use blunt instruments. This bill, even for physical presence states, will preempt every nexus standard in every state.

Mr. JOHNSON. What is it specifically that you would recommend to get at this problem? And certainly it is a problem.

Mr. QUAM. I think the first place to start is you can look at the MTC's formula for nexus?

Mr. JOHNSON. MTVs?

Mr. QUAM. MTC.

Mr. JOHNSON. MTC.

Mr. QUAM. Multistate Tax Commission.

Mr. JOHNSON. Okay.

Mr. QUAM. Came up with, again, a model for states that states could adopt.

Mr. JOHNSON. What is it called?

Mr. QUAM. Multistate Tax Commission.

Mr. JOHNSON. The Multistate Tax Commission has come up with a business activity tax model that can be——

Mr. QUAM. A nexus, uh-uh. It is a place to start. It is a place where both the states and the businesses can come together and talk about—if the constitutional standard today is economic presence, and that is what it is, then let us start from that construct. Let us create the certainty we need. States have entered those conversations before and would be willing to do it. But until that time, for this Committee to go to a solution that instead is going to create tax avoidance and preempt all states with a more blunt instrument, governors cannot support that at the end of the day. It violates that do no harm principle and violates the sense of do not unnecessarily preempt, do not take a step more than you have to when it comes to state tax laws.

Mr. JOHNSON. Mr. Henchmen, does that sound reasonable to you?

Mr. HENCHMAN. I am sure what the gentleman's basis is for saying economic presence is the law of the land. The Supreme Court has never ruled that. Congress has certainly never legislated that. If anything, it has been the other way. Physical presence has been the standard since the Constitution.

So let me just explain why economic presence would be a problem using the examples of the two people you had here. So Mr. Vegas makes a product that goes into french fries from his two facilities in Arkansas, and those are where all of his employees are, where their kids are going to school, where they see doctors, where they use police and fire services. That is where they are paying taxes, and that is where the services are being received.

Under economic presence, what would matter is where his products were sold, so anywhere where french fries are, which I imagine is all 50 states and every country in the world. So somebody in East Timor buys a french fry, that means he has got to fill out a corporate tax return for East Timor?

I mean, in the end what that does is it turns the corporate income tax into a sales tax because you are now measuring it all by sales. And, you know, states have sales taxes and they can charge sales taxes for that kind of stuff. What we are talking about are business activity taxes, and those should be premised on the location of property and employees of the business.

Mr. JOHNSON. Mr. Vegas, do you mean to tell me, I'm 59 years old, and I have always had confidence and been self-assured about every french fry that I have ever eaten, that it was potato based. And now you are telling that it is rice based? [Laughter.]

Mr. VEGAS. Almost all but one chain has some rice in it.

Mr. JOHNSON. My goodness.

Mr. BACHUS. Rice is very good for you. [Laughter.]

Mr. VEGAS. Since you opened me up, can I just mention one thing that people seem to be confused about?

Mr. JOHNSON. Okay.

Mr. VEGAS. Business and occupation tax——

Mr. JOHNSON. Well, I thought you were going to talk about french fries. I am real confused about that, but go ahead, sir. [Laughter.]

Mr. VEGAS. Let me say this because I think it is important, and a lot of people do not get it. Business and occupational tax is an additional tax, okay? If you go back to the old standards, which still apply in a lot of states. For example, I have facilities in Arkansas. Arkansas has a 7 percent income tax. So if half my business is in Arkansas, they get 7 percent of half of my income. But that does not kill me because I pay taxes in California that are actually higher, 13 percent, so they deduct it. So when you are dealing with income taxes, the highest tax you can pay is whatever the highest state you are dealing with, which is about 13 percent of this country when you get into New Jersey and California.

These business and occupational taxes are in addition. Okay. They do not get deducted from my income tax. It is a new tax, so they are just adding onto what we are already paying.

Mr. BACHUS. Thank you, Mr. Johnson.

Mr. JOHNSON. Thank you.

Mr. BACHUS. I would let Mr. Marino and then I will let the gentlelady from Washington who has come in to put out a fire here.

Mr. JOHNSON. Well, if I might, Mr. Chairman, just to say that my mind is all messed up now, Mr. Vegas. [Laughter.]

Mr. BACHUS. Thank you. Mr. Marino?

Mr. MARINO. I am sorry for being late. I have three full Committee hearings today and six Subcommittee hearings, and I am trying to at least touch base with each one. I am not going to ask any questions because I did not hear what was going on, and I am sure it would be repetitive to a certain extent. I just want to thank you for being here.

And with that said, this talk about french fries, I have not eaten all day, so I do not care if it has rice in it or not. I will eat the french fries if you get them to me. Thank you. [Laughter.]

Mr. BACHUS. Yielded back your time?

Mr. MARINO. Yes.

Mr. BACHUS. Ms. DelBene?

Ms. DELBENE. Good job. So you are getting it now.

Mr. BACHUS. Yes.

Ms. DELBENE. He has been practicing pronouncing my name. Thanks to all of you for being here today. I will be quick because I know they called votes.

Mr. Quam, when we look at the economic environment today, we have millions of U.S. customers who are buying things online. I assume you have bought things on line as well.

Mr. QUAM. Absolutely.

Ms. DELBENE. And the Census Bureau at the Department of Commerce announced just last week that total e-commerce sales for 2013 were estimated to have increased almost 17 percent from 2012 to the tune of about $263 billion in 2013. And this obviously has had huge opportunity and created innovation, and economic growth, and jobs. But it has also just changed the way folks do business across our country.

And now that we have that, we know that we need to have tax policies that are user friendly, that are workable, that provide clarity, that everyone has talked about here, clarity and certainty to businesses and individuals. And I definitely support that. But I also think it is important that we look at the way our economy works today and figure out solutions that are up to date.

Given that there is major economic activity that is going across state borders, and many cases, for example, on the internet with limited physical presence, we need to take a close look at the physical presence standard and whether this proposal might have unintended consequences. I think you have talked about that.

But, you know, the Supreme Court had their decision, Quill. It is over 20 years old now. And although it has come up in the context of this business activity tax bill, the case was actually about sales tax originally. What have been the consequences of that decision on states, especially given now that we have the internet and a slightly different economy than when that decision was made? And what steps would you like to see Congress take on this issue, if any?

Mr. QUAM. I very much appreciate the question. Yes, I have bought things recently on the internet, as have my sons, as have probably most everybody here. And the internet has been such a boom to the economy. You talked about growth numbers at 17 percent. Coming out of the last 5 years, what other sector can you possibly say that about other than the internet?

Now, interestingly enough, because of the Quill decision and that physical presence standard, we have an uneven playing field when it comes to sales tax and sales tax collection. And the Marketplace Fairness Act, which is supposed to talk about what can states do to simplify their sales taxes, to ease compliance, but require collection, so that folks doing business both online or on Main Street are on the same footing with regard to those sales, is a critical question of fairness. And right now, that playing field is unlevel.

And so, one of the top priorities for the National Governors Association is the Marketplace Fairness Act and addressing that question of the inequity caused by a physical presence standard in the sales tax realm. The Marketplace Fairness Act would create certainty. It would create fairness. It would simplify and the states would simplify their taxes in return for that authority to require that collection.

States today cannot collect about $23 billion in sales tax because of the Quill decision. States came together with the business industry—I think this is really critical—to address that problem and say what simplifications are needed. The Streamline Sales Tax Agreement is the collective efforts of business and states to solving the national problem and say how do we do this together. And at the end of the day, that is also good for consumers. It is good for consumers because they see competition and they have competition, but also protects the Main Street retailer who is hiring the part-time worker. It becomes about jobs. It also becomes about fairness in that economy.

So the physical presence standard created that inequity. Finding a way to, in a borderless economy, just recognize the right of states to control their own revenue systems, recognize our Federal system when it comes to state taxation, but also find a way to recognize that borderless economy, the internet economy, and create fairness so there is competition in that marketplace. I think that should be the focus of this Committee and its top priority. My fear is that this bill goes in the opposite direction.

Ms. DELBENE. Thank you. Since we are running out of time here, Mr. Chair, I would like to ask for unanimous consent to enter into the record a statement from the Federation of Tax Administrators.

Mr. BACHUS. Without objection.

[The information referred to follows:]

STATEMENT OF THE

FEDERATION OF TAX ADMINISTRATORS

ON

H.R. 2992 – THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2013

TO THE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

OF THE

U.S. HOUSE OF REPRESENTATIVES, JUDUCIARY COMMITTEE

FEBRUARY 26, 2014

FTA is an association of the tax administration agencies in each of the 50 states, the District of Columbia, New York City and the City of Philadelphia. FTA strongly opposes H.R. 2992 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?

Note: These figures below have not been updated for the 2013 version of the bill. 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. In 2011, the CBO estimated that the a prior version of the BATSA bill, H.R. 1439, would cost states $2 billion in the first full year and "at least that amount in subsequent years."

The revenue loss estimates have been updated and are continuing to be 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 2000-2013, State Corporate Income Tax Rates, 2011*," The Tax Foundation, http://taxfoundation.org/article/state-corporate-income-tax-rates-2000-2013, March 22, 2013.

[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

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.*

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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.

[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).

denied, 114 S.Ct. 550 (1993); *Comptroller of the Treasury v. SYL, Inc.*, and *Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 124 S.Ct. 961 (2003); *A&F Trademark, et al. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *review denied* (N.C., 2005), *cert. denied*, 126 S.Ct. 353 (2005); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), *cert. denied*, 122 S.Ct. 1915 (2002); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), *cert. quashed* (N.M., 12/29/05); *Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla., 3/20/06); *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (Ill. App. Ct. 2000), *appeal denied*, 731 N.E.2d 762 (Ill. 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]

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

[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).

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 jurisdiction 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]

[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 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.

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 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)

[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).

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, a number of states have issued assessments against such holding companies that have been affirmed by the courts."[10] Consequently, this type of aggressive tax planning has been substantially reduced. 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 bill's 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. Under BATSA, the out-of-state retailer would not be subject to a business activity tax in

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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).

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, provided they do so in a non-discriminatory manner. Moreover, the companies supporting BATSA have found plenty of avenues for making their desires known to state elected and appointed officials. Most

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

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

The current system of state taxation has developed over many years and we believe it is fundamentally sound. Legislation like H.R. 2992 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.

Ms. DELBENE. Thank you. I yield back.

Mr. BACHUS. And if you need more time.

Ms. DELBENE. That is fine. I know we have to——

Mr. BACHUS. All right, thank you. Well, we thank everyone for their attendance at this hearing. I was thinking about Boeing airplanes. They land at all the airports in the country. I may tell my counties to start taxing Boeing because their product comes into all our cities. That is an economic presence, I guess.

This concludes today's hearing. Thanks to all our witnesses for attending. Without objection, all Members will have 5 legislative days to submit additional written questions for the witnesses or additional materials for the record.

This hearing is adjourned. We thank you for your presence.

[Whereupon, at 4:05 p.m., the Subcommittee was adjourned.]

A P P E N D I X

MATERIAL SUBMITTED FOR THE HEARING RECORD

Testimony of the National Marine Manufacturers Association

United States House of Representatives

Committee on the Judiciary's

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

February 26, 2014

Chairman Bachus, Ranking Member Johnson, and Members of the Subcommittee, thank you for holding a hearing on H.R. 2992, the Business Activity Tax Simplification Act ("BATSA"), passage of which will greatly help the many small businesses struggling to get back to back on their feet after the great recession . The National Marine Manufacturers Association (NMMA) is pleased to provide the following testimony to the committee regarding H.R. 2992.

BACKGROUND

By way of background, NMMA is the leading recreational marine industry trade association in North America, representing 1,400 boat, engine, and accessory manufacturers. NMMA members collectively produce more than 80 percent of the recreational marine products sold in the United States. Recreational boating is a significant contributor to the US economy, employing nearly 340,000 people through more than 34,800 boating businesses. The total economic impact for recreational boating in the US was $121.5 billion in 2012.

Traditionally, the courts have interpreted the US Constitution's Commerce Clause to require physical presence nexus – that is, a business must have a physical presence in a state before the state is permitted to assess income-based taxes. Increasingly, however, state and local taxing officials are attempting to apply "economic nexus" standards in an aggressive effort to collect business activity taxes from businesses that are located entirely in other states, even though such businesses receive no appreciable benefits from the taxing jurisdiction. In the last two years, some state tax enforcement agencies have demanded that boat manufacturers pay millions of dollars in back-taxes, interest, and fines in states where they had no physical presence. The complexity and cost of understanding and complying with inconsistent and vague state tax nexus rules is detrimental to interstate commerce and hurts marine manufacturers doing business across state lines.

ISSUE

The attempts by state and local taxing officials to apply economic nexus has led to considerable unfairness and uncertainty and generated contentious, widespread litigation. This uncertainty has hindered business expansion, as businesses shy away from expanding their presence in other states for fear of exposure to unfair tax burdens. Such obstacles to business expansion slow the American economy and negatively impact the international competitiveness of U.S. companies.

Efforts by states and localities to expand their taxing jurisdiction to cover activities conducted in other jurisdictions will continue to retard business growth and economic development in America if current law is not modernized. Clear and equitable nexus standards consistent with constitutional principles must be implemented to reduce complexity. Left unchecked, this taxation without representation and unwarranted expansion of the state and local authority to impose business activity taxes will have a chilling effect on the entire economy, including marine manufacturers, as tax burdens, compliance costs, litigation, and uncertainty escalate.

NMMA POSITION

NMMA believes that its members should continue to pay business activity taxes in those states where they receive direct benefits and protections, such as police, fire, sanitation, public schools, and roads — in other words, where they have a physical presence. On August 2, 2013 Congressman James Sensenbrenner (R-WI-5) introduced H.R. 2992, the Business Activity Tax Simplification Act (BATSA).

BATSA would clarify that the Constitution requires a business to have a physical presence in a state before that business can be subjected to the state's business activity tax. The legislation is designed to clarify the definition of "physical presence" so businesses will know which activities trigger nexus in a state, significantly reducing room for many different interpretation of the nexus standard. Because so many boat manufacturers conduct business across state lines in jurisdictions where they have no physical presence, BATSA would save boat manufacturers millions in state taxes levied upon, for example, warranty repairs and ownership transfers among dealers. At the same time, enactment of the bill would ensure that those companies pay all business activity taxes owed to states in which they have real property, inventory or employees.

The legislation would ensure fairness, minimize litigation, create the kind of legally certain and stable business climate that encourages businesses to make investments, expand interstate commerce, grow the economy, and create new jobs. BATSA would also 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.

ACTION NEEDED

Congress needs to act now to protect our businesses and promote a healthy, stable business economy. NMMA and its members strongly urge Congress to pass H.R. 2992 the Business Activity Tax Simplification Act (BATSA) during the 113th Congress. Again, NMMA thanks the Committee for allowing us to submit testimony on this very important topic. If the Committee needs further information, please contact NMMA Legislative Counsel Jeffrey Gabriel at jgabriel@nmma.org.

Testimony of Grady-White Boats
United States House of Representatives
Committee on the Judiciary
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
February 26, 2014

Chairman Bachus, Ranking Member Johnson, and Members of the Subcommittee, thank you for holding a hearing on H.R. 2992, the Business Activity Tax Simplification Act ("BATSA"), passage of which will greatly help the many small businesses struggling to get back to back on their feet after the great recession . Grady-White Boats is pleased to provide the following testimony to the committee regarding H.R. 2992.

One of the most successful boatbuilding companies in the world, Grady-White Boats has a legendary reputation for designing and producing outstanding fiberglass boats. Since 1959, Grady-White boats have been built in Greenville, NC. And since purchasing the company in 1968, owner and CEO Eddie Smith steadily has done what he does best: inspire our crew to work hard to provide customers the best quality, reliability, safety, performance and long lasting value. In large part Grady-White's success is due to developing close relationships with its customers and dealerships, asking questions of and carefully listening to boat owners, and incorporating features they've requested to create fun products that make many happy memories. The history of Grady-White reflects nearly fifty years of appreciation and respect for these gifts, and the company is a steadfast advocate of fisheries conservation and education, and waterways management. Perhaps the best way to share with this Subcommittee the difficulties faced by small businesses as a result of the current hodgepodge of business activity tax nexus standards claimed by the states is to tell you about our own experience. It began like this:

On April 25, 2006, we received a phone call from one of the gentlemen who we contracted with to deliver boats to our dealerships. He was on his way to New York to deliver a load of boats. He was calling from New Jersey to tell us that when he made a routine stop at a weigh station he was questioned about who he worked for, where he was going, etc. He answered their questions to the best of his ability and was told he could not move the load of boats until Grady-White paid back taxes owed to the state of New Jersey.

Considering that we had customers waiting for these boats and the state of New Jersey would not release them until we paid the very significant amount they were demanding, we had a very pressing problem. We immediately sought legal counsel and after much discussion were left with no better option at the moment than to pay the state of New Jersey so that our boats could be delivered to our dealer. I want to emphasize that we do not currently have nor did we have then any real property, employees or inventory in New Jersey. After the boats were delivered, we worked diligently to try to get our money back although the legal fees were significant. Months later, we were able to recoup about 75% of the dollars paid (which was really only 50% after legal fees) and we have had to file income tax returns in New Jersey annually since then.

In later years, other states where we lack any physical presence have approached us for payment of business activity taxes, and we have been forced to file income tax returns with them as well. We have also initiated the filing of tax returns in some states just to prevent another situation like the nightmare we experienced in New Jersey. All this required more legal fees because each state's nexus laws are different and have to be interpreted. Although these taxes are offset by reduced taxes in North Carolina, we still have the continuing annual cost of filing additional returns. Also, for obvious reasons, we would much prefer that these tax dollars stay in our state.

Essentially, New Jersey held our business hostage to determine if we made enough money to make their taxing financially worthwhile. How in the world is a business supposed to operate in interstate commerce when states are allowed to create just about any theory to tax a company's income, without legitimate legal certainty, and then place liens, without notice, on assets? Clearly, the framers of our Constitution included the Commerce Clause to prevent the states from bullying and cajoling nonresident business into paying taxes based on novel arguments like "economic nexus." If the Congress does not step in to address this problem, there is no way that American small businesses can be expected to succeed.

On behalf of Grady-White Boats and thousands of other small and medium size businesses like ours, we respectfully urge that the Committee consider and favorably report out H.R. 2992, the Business Activity Tax Simplification Act of 2013. As you know, that bill would resolve current uncertainty and unfairness associated with varying nexus rules applied by the states with respect to the taxation of the income of nonresident companies. That uncertainty and unfairness has a significant negative impact on interstate commerce, and the burdens it creates, especially those caused to small businesses, increase exponentially as more time passes without a federally mandated solution to the problem.

H.R. 2992 represents an opportunity to protect small businesses from the "creative" tax schemes developed by some states to generate tax revenues from businesses, including more vulnerable small businesses, which have no physical presence in the taxing jurisdiction. Essentially, H.R. 2992 would prevent states from redefining the constitutional limits on state taxation of interstate commerce and guard against the resulting threat to the development of our national economy.

Grady-White Boats is committed to paying all tax rightfully owed. But, clear, predictable and equitable standards for state taxation of interstate business are essential to drive the economy for the benefit of consumers and businesses, large and small. Unless Congress acts quickly to enact H.R. 2992, our business and others that operate across state lines will continue to suffer contractions of investments, employment and profit. Given the current state of the economy, that scenario presents a real threat to our survival.

Thank you for the opportunity to comment.

Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Committee on the Judiciary

United States House of Representatives

February 26, 2014

The American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record for the hearing held on H.R. 2992, the Business Activity Tax Simplification Act of 2013 (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 $14 trillion in assets and employ more than 2 million men and women.

Today, banks of all sizes face the difficulties associated with the uncertainty of states' business activity taxes. The differences in the application of the tax greatly increase compliance and legal expenses that will ultimately be borne by customers and our economy at large. ABA strongly supports BATSA, which would modernize existing law to ensure that states and localities can only impose their business activity taxes in situations where an entity has physical presence (i.e., property or employees) and thereby receives related benefits and protections from the jurisdiction. ABA appreciates the leadership of Representatives Jim Sensenbrenner and Bobby Scott in introducing this legislation, and we encourage Congress to enact it in order to provide businesses with more certainty on this issue. There are three key points we wish to make:

- Inconsistent and unclear taxation standards between states subject businesses to litigation and other onerous business costs, which are especially harmful to small businesses.
- Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs.
- BATSA will help minimize litigation costs and uncertainty for businesses by clarifying that entities must have a physical presence in the taxing jurisdiction in order to be subject to state and local taxes.

I. Inconsistent and unclear taxation standards between states subject businesses to litigation and other onerous business costs, which are especially harmful to small businesses.

An increasing number of states have enacted, or are considering, legislation that would lower the threshold of what constitutes "substantial nexus" for purposes of taxing a business' activity within the state. However, there is no uniform definition or application of "substantial nexus" among the states and no set rules or parameters for determining how a state would apply the nexus standard – it varies from state to state. Therefore, each state applies its own nexus standard to determine when an out-of-state business that is operating within the state is required to pay income tax. In fact, in some states, the presence of even one customer within the state would establish the state's required nexus for applying its business income tax to an out-of-state business.

This type of application of the nexus standard is devastating for small businesses, especially community banks, because they do not possess the substantial resources required to comply with a proliferation of disparate state tax laws. There are 2214 banks and savings associations with fewer than 25 employees. 553 of them have fewer than 10 employees. Many of these community banks operate near state borders and serve customers from more than one state. Additionally, many financial institutions now provide services to customers online, which allows people nationwide to take advantage of increased competition and better services to fit their individual needs. Without a uniform standard, these institutions are finding themselves subject to different standards that result in undue costs and burdens.

II. Greater certainty for businesses will foster a more stable business environment that encourages investment and creates new jobs.

The additional costs resulting from the application of disparate standards divert resources businesses could invest in areas such as product innovation, improved customer service, or additional employees. 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 to create a substantial nexus. It would also include a bright-line test that would establish a minimal amount of activity a business must perform in a state before it is subject to income taxes and additional paperwork. Finally, this bill would help limit businesses' exposure to unanticipated taxes, and thus reduce compliance and legal costs associated with frivolous nexus claims.

ABA strongly supports this legislation and hopes that Congress will work quickly to pass it. ABA applauds Representatives Jim Sensenbrenner and Bobby Scott, who have introduced H.R. 2992 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.

Prepared Statement of

American Trucking Associations

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Committee on the Judiciary

United States House of Representatives

February 26, 2014

Hearing on H.R. 2992
The Business Activity Tax Simplification Act

Mr. Chairman, Ranking Member Johnson, and members of the Subcommittee:

The health of this Nation's economy depends critically on interstate commerce, and interstate commerce in turn depends very heavily on efficient freight transportation. Most of that freight is carried by truck – over 68% by tonnage and some 81% as measured by transportation receipts. The interstate motor carrier industry is correspondingly large, comprising several hundred thousand for-hire trucking companies. Although a few carriers are large, the overwhelming majority of trucking companies are, by any definition, 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 travel into dozens of states in the regular course of their business.

Our industry faces a serious threat of disproportionate compliance costs related to state business taxation, 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] We emphasize that our industry's primary concern in this area is compliance costs rather than the amount of taxes involved. The relief we request should affect aggregate state revenues little if at all. 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; fewer than 3% operate more than twenty. American Trucking Assns., *American Trucking Trends 2013*, ATA: Arlington, VA, 2013, p. iv.

[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 nearly 2,000 trucking companies and suppliers of motor carrier equipment and services. Directly and indirectly through our affiliated organizations, ATA encompasses over 37,000 companies and every type and class of motor carrier operation.

Prior Congressional Action

Time and again since 1980, Congress has had to step in to protect the motor carrier industry from the effects of state and local taxation, to restrict the taxing authority of these jurisdictions and the manner in which they may administer otherwise 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 the motor carrier industry the relief it 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 in 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 recent recession was very hard on the trucking industry, as it was on so many other businesses. The deregulated industry had never faced times like these. Motor carriers that have survived the last few years now face both very high fuel prices and unprecedentedly high prices for the replacement of their equipment. Those higher truck prices are driven in large part by the cost of environmental regulation, and smaller trucking operations are in many instances hard-pressed to find financing for the equipment they need to buy. Unwarrantedly high state and local tax compliance costs are, for a growing number of our members, another source of hardship.

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

[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., *2012 American Trucking Trends*, *op. cit.*, p. 17.
[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.

proportion of their business may occur.[8] Indeed, the typical smaller trucking operation has but one place of business – in its home state – and has no property or payroll in any other jurisdiction.[9]

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 assessed some 40,000 interstate motor carriers in this manner over the last decade, most of them small businesses.[10] New Jersey does accord a carrier the option of appealing an assessment – once it has been paid – but the process is long, laborious, expensive, and uncertain.

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 difficult 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

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[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 – which, under Congressional mandate (*see*, 49 U.S.C. 31701, *ff.*), ensure that all states administer these tax programs by means of a uniform structure that guarantees to 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] 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 hard economic times, 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.

to the state.[11] Companies that answer the questionnaire and return it – and those that do not return it receive increasingly threatening communications from the state until they do – typically then receive a further letter from the state, advising them that the state has determined that they have nexus there and enclosing a bill, typically for several years (occasionally even decades) of back taxes, plus penalty and interest.

Particularly for smaller motor carriers, this is a cruel absurdity. Typically, the state that seeks to force interstate motor carriers to pay its business taxes not only assesses for years of back taxes, but also either imposes a minimum corporate tax or taxes gross rather 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 single, 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.

It is these compliance costs – the accountant's costs, and the sheer labor, time, and trouble involved in complying with numerous varying state requirements – of which our industry most complains. Trucking companies are not trying to avoid their tax obligations; they understand that the government services they really avail themselves of must be paid for. But they do object to paying exorbitant costs for complying with the requirements of states where they have no establishment, where they have little business, and where the nexus rules, where they published at all, are extremely vague as regards interstate trucking operations.

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

[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.
[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.

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. Many motor carriers, typically on the advice of their accountants, file in many more states than may be warranted, and spend thousands of dollars annually in accountants' fees to pay perhaps hundreds of dollars or less in state taxes.[15] Others, in the absence of any indication from a state that out-of-state carriers need to file there, forego filing until suddenly the state changes its position and sends out bills for three, five, seven, or more years of back taxes to thousands of interstate carriers. Motor carriers commonly find it extremely difficult to pass on these compliance costs to their customers.

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 urgently needed.

A Federal Solution

For the reasons we have outlined, interstate motor carriers are now approaching Congress for relief from the efforts of states to impose their taxes on interstate trucking companies that have only 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

[13] In fact, the leading case in this area, *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), involved state taxation of a motor carrier.
[14] Nebraska and New Mexico have recently asserted nexus for motor carriers on the basis solely of such "pass-through" miles, no other contact with the state being, in their view, legally necessary. Carriers that ignore or question Nebraska's collection efforts may have liens filed against their equipment.
[15] Filing in many states has another danger for interstate motor carriers: overlapping state apportionment formulas can capture more than all of a carrier's net income for state taxation. *See*, for example, *Consolidated Freightways Corp. of Delaware v. Wisconsin Dept. of Revenue*, 477 N.W.2d 44 (Wisc., 1991).

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 – and interstate commerce, to which trucking is so critical – need protection from taxation by a state when they do not have a significant physical or legal establishment within its borders. *Nor, because of our industry's operations, would a solution such as that offered by the Business Activities Tax Simplification Act, H.R. 2992, provide much relief to motor carriers. The provisions of that legislation would leave the nexus rules for motor carriers largely undefined.*

We recommend that Congress pass legislation that would permit a state to impose a business tax on a for-hire interstate motor carrier only if that carrier has real property or has obtained intrastate operating authority in that state, or is incorporated or has its principal place of business in that state. This will leave the vast majority of motor carriers to report and pay business taxes only at home, and would leave the aggregate state taxes collected from the motor carrier industry as a whole substantially unchanged. In many respects, our proposal closely resembles the relief we cited earlier that Congress enacted for truck drivers, when those employees were being harassed by states they merely drove through in furtherance of interstate commerce. Local government impositions on motor carriers can also be a significant burden. Congress should extend whatever relief it may enact with respect to state motor carrier taxation to cover local taxes as well.

We anticipate that a bill incorporating our solution to this pressing problem will shortly be introduced. We recommend it to the Committee's attention, and urge Congress to enact such relief for motor carriers promptly.

We appreciate very much this opportunity to testify before the Committee.

Robert C. Pitcher
Vice President, State Laws
American Trucking Associations

COST
Council On State Taxation

Douglas L. Lindholm
President & Executive Director
DLindholm@cost.org

March 4, 2014

VIA EMAIL

The Honorable Spencer Bachus, Chairman
The Honorable Hank Johnson, Ranking Member
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
Committee on the Judiciary
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

Re: Hearing on H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

Dear Chairman Coble and Ranking Member Cohen:

Thank you for the opportunity to submit this statement for the record for the February 26, 2014 hearing on H.R. 2992 on behalf of the Council On State Taxation (COST). COST supports H.R. 2992 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 more than 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.

The BAT Nexus Issue 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 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 a 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.

Conclusion

In 1992, the Supreme Court invited Congress to legislate in the arena of nexus. More than twenty years later there has yet to be Congressional action on this matter. 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. It is for all these reasons that COST respectfully requests swift and favorable action on H.R. 2992.

Sincerely,

Douglas L. Lindholm

CC: COST Board of Directors

MOTION PICTURE ASSOCIATION
OF AMERICA, INC.
1600 EYE STREET, NORTHWEST
WASHINGTON, D.C. 20006
(202) 293-1966

March 5, 2014

The Honorable Spencer Bachus, Chairman
The Honorable Hank Johnson, Ranking Member
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
House Judiciary Committee
United States House of Representatives
Washington, D.C. 20515

Re: Hearing on H.R. 2992: The Business Activity Tax Simplification Act of 2013

Dear Chairman Bachus and Ranking Member Johnson:

On behalf of the Motion Picture Association of America ("MPAA")[1] I thank you for the opportunity to submit this statement for the record for the February 26, 2014 hearing on H.R. 2992: The Business Activity Tax Simplification Act of 2013.

I. Introduction

The MPAA has a particular interest in business activity tax nexus and specifically in H.R. 2992 (the Business Activity Tax Simplification Act or BATSA). The MPAA strongly supports H.R. 2992 and respectfully urges your Subcommittee and the Judiciary Committee to markup and report out this legislation for consideration by the full Congress. The MPAA believes that a bright-line physical presence standard as provided in H.R. 2992 is the appropriate jurisdictional standard for state business activity tax purposes. In recent years, an increasing number of states have asserted that a business's mere economic presence in a state is sufficient to subject that out-of-state business to the state's direct business tax. Due to the lack of clear judicial guidance on this issue, states are taking varying, inconsistent and often aggressive positions with respect to the particular activities that may cause an out-of-state business to become subject to tax. These actions have created an environment of uncertainty and unpredictability for multistate businesses, especially businesses in the film, television and media-related industries when such businesses have no physical presence in the state.

This issue is of particular concern to the MPAA because of the aggressive actions taken by states in recent years against film companies, and related entities, such as broadcasters. For example, states have asserted business activity taxes against film and broadcasting companies claiming "economic nexus" on the following:

- Asserting that an out-of-state broadcaster should be subject to business activity tax in a state solely because the company's broadcast signals are viewed by residents in the state;
- Asserting that the digital transmission of movies to in-state customers creates nexus for an out-of-state film company for business activity tax purposes; and
- Asserting that an out-of-state film company should be subject to business activity tax if the company licenses brands, names, characters or other trademarks to unrelated third parties, who subsequently manufacture and sell merchandise bearing the licensed trademark into the state.

These examples are illustrative and only represent a few of the many state tax jurisdictional issues currently faced by the film, television and media-related industry due to inappropriate state actions.

[1] MPAA member companies include Paramount Pictures; Sony Pictures Entertainment Inc.; The Twentieth Century Fox Film Corporation; Universal City Studios LLLP; Walt Disney Studios Motion Pictures; Warner Bros. Entertainment Inc; and associate member CBS Corporation.

II. H.R. 2992 Provides the Appropriate Solution

Detailed below are some of the more aggressive positions taken by states that are aimed at taxing out-of-state film companies and broadcasters and the arguments advanced by states to support these positions. The MPAA believes that a physical presence nexus standard is the more appropriate jurisdictional standard for state business activity tax purposes. The provisions to modernize Public Law 86-272 contained in H.R. 2992, and the physical presence nexus standard provisions, are both fair and necessary because they are consistent with notions of where income is earned, ensure that businesses are only paying tax to those states that have provided the businesses with meaningful benefits, and represent the application of existing federal law to modern day business transactions.

Broadcast Programming. Some states have asserted that out-of-state national broadcasters should be subject to business activity taxes solely because these companies' broadcast signals, which are in turn transmitted by cable operators and local television stations, are received by in-state viewers or listeners. States have tried to justify the taxation of these out-of-state broadcasters on the basis that the out-of-state broadcasters are exploiting the in-state market because the programming is seen and/or heard by individuals in the state. However, this rationale fails to recognize the basic business model employed by most national broadcasters. Specifically, broadcasters do not generate revenue from viewers or listeners. Rather, broadcasters receive revenue from advertisers that purchase air time and, in the case of cable program networks, from cable operators that license the programming. The advertisers and cable operators are the "customers" of the out-of-state broadcaster, not the in-state viewers or listeners who are the customers or potential customers of the advertisers and the cable operators. Thus, broadcasters are not "exploiting" the local market when programming is aired for individual viewers or listeners in a state. Further, broadcasters should only pay tax where they earn income, and, as discussed in more detail below, income is only earned where a business is physically located.

Notably, the states' position is inconsistent with the U.S. federal income tax treatment of foreign broadcasters. In fact, the issue of whether the United States may impose federal income tax on a foreign broadcaster that has no physical presence in this country has been litigated, and federal courts have held that the United States cannot impose such a tax. [2] This holding is reinforced by the "permanent establishment" standard that the United States, along with most other countries, has adopted in its bilateral tax treaties. The permanent establishment standard requires taxpayers to have a fixed place of business (i.e., a physical presence) through which the business of the enterprise is wholly or partly carried on in order for a foreign country to impose an income tax on the business's profits. If states continue to assert positions that contradict these well-established longstanding federal tax principles, it could be potentially disastrous for America's interstate and international economy. On the other hand, the physical presence standard in H.R. 2992 is consistent with the standard used for the U.S. federal income tax treatment of foreign broadcasters, and would only tax out-of-state broadcasters that have a physical presence in the state.

Use of Trademarks in State by Unrelated Third Parties. Several states have attempted to assert taxing jurisdiction over out-of-state film companies that license brands, names, characters or other trademarks to unrelated third parties who then manufacture and sell merchandise for their own account bearing the licensed trademarks, for instance, within the state. A recent survey of state tax departments revealed that more than 30 states take the position that the licensing of trademarks to either affiliated or unrelated entities with a location in the state would create nexus for the licensor for corporation income tax purposes.[3] These states are overreaching and attempting to tax income that is earned outside of the states' borders.

Film companies do not earn their income in the states where merchandise bearing their trademarks is sold by third parties; rather, they earn their income where they actually engage in business activities (i.e., where they have property and employees). The physical presence nexus standard contained in H.R. 2992 would ensure that income is only taxed in those states where the income is earned.

Digital Transmission of Movies. Some states have asserted that out-of-state film companies should be subject to business activity tax if the out-of-state company sells digital films to in-state customers who download the films over the Internet. States assert that they are entitled to tax these out-of-state sellers because the state has provided an

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[2] *See Commissioner of Internal Revenue v. Piedras Negras B. Co.*, 127 F. 2d 260 (5th Cir. 1942).

[3] *Special Report: 2008 Survey of State Tax Departments*, 15 Multistate Tax Rep't 4 at S-28 (April 25, 2008).

in-state market for digital product. However, state governments maintain a "viable marketplace" for the benefit of their constituents, the in-state customers, and not for the benefit of out-of-state sellers. Further, the imposition of a business activity tax on an out-of-state seller simply cannot be justified on the basis that the government has provided some nebulous and incidental benefit. Rather, the benefits and protections provided by a taxing jurisdiction must be meaningful to warrant the imposition of a business activity tax. Businesses only receive these meaningful benefits and protections (e.g., education, roads, police and fire protection, water and sewers) in the jurisdictions where they are actually located due to the presence of a labor force or property. Further, as previously discussed, businesses should also only pay tax to those states where income is earned, and income is simply not earned where a business's customers are located. Thus, businesses should only pay tax to those jurisdictions where they are physically present. H.R. 2992 would promote fairness by ensuring that businesses are only taxed by those jurisdictions that have provided meaningful benefits and protections, and in those jurisdictions where income was earned.

In the context of digital downloads, we should also point out some of the peculiar results that can arise if Public Law 86-272 is not modernized for today's economy and modern technologies. For example, if an out-of-state film company conducts in-state solicitation activities aimed to promote the sale of DVDs (i.e., tangible personal property), the orders for which are accepted and shipped or delivered from outside the state, this in-state solicitation would be protected under current law by Public Law 86-272. On the other hand, if an out-of-state film company were to conduct the same in-state solicitation activities to promote digital downloads (i.e., intangible property) for the very same film, these solicitation activities would not be protected by Public Law 86-272. This example clearly demonstrates why the provisions of Public Law 86-272 must be modernized, as provided in H.R. 2992, to protect the solicitation of orders for services and intangible property. As our economy continues to shift towards intangibles and services, it is important that these sectors of the economy be afforded the important protections of Public Law 86-272.

Finally, H.R. 2992 includes a provision intended to prevent states from circumventing the intent of the legislation. Under that provision, states that require or permit a group of affiliated corporations to use a combined reporting tax return methodology to compute the tax liability of corporations within the affiliated group that are subject to a state's taxing jurisdiction under the tax nexus standards of H.R. 2992 may not indirectly impose tax on the group members that are not themselves subject to tax in that state under such tax nexus standards. Thus, H.R. 2992 prohibits a state from taxing a corporation that is not otherwise subject to tax in the state by using the end-around run frequently referred to as the Finnigan method of combined reporting. The MPAA supports this critical element of H.R. 2992.

III. Conclusion

The MPAA believes that it is necessary for Congress to provide clear guidance to the states in the area of state tax jurisdiction and put a stop to the aggressive actions being taken by the states. In the absence of Congressional action, these state actions will likely have a chilling effect on interstate commerce. H.R. 2992 would provide a much needed bright-line physical presence standard that is both fair and reasonable, and would modernize Public Law 86-272 to account for the current state of our economy. As states continue to attempt to maximize revenues, they will likely become even more aggressive in their attempts to tax out-of-state businesses making the need for Congressional action all the more urgent. Therefore, the MPAA strongly urges your Committee to include the provisions of H.R. 2992 in any package of legislation affecting state taxes that your Committee considers and approves.

Sincerely,

Michael O'Leary
Senior Executive Vice President for Global Policy and External Affairs
Motion Picture Association of America, Inc.

Center on Budget and Policy Priorities

820 First Street, NE, Suite 510 Washington, DC 20002
202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

February 26, 2014

The Honorable Bob Goodlatte, Chairman
The Honorable John Conyers, Jr., Ranking Member
Judiciary Committee, U.S. House of Representatives
2138 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Goodlatte and Representative Conyers:

In connection with the hearing being held today concerning H.R. 2992, The Business Activity Tax Simplification Act of 2013, our nonpartisan Center on Budget and Policy Priorities respectfully submits for inclusion in the hearing record the enclosed two analyses I have written on this legislation.

The first report, "Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy," details the adverse impact that BATSA would have on the ability of states and localities to ensure that businesses pay a fair share of the costs of the state and local services from which they benefit. The second report, "Proponents' Case for a Federally-Imposed Business Activity Tax Nexus Threshold Has Little Merit," responds to the supporters' arguments as to why the legislation is needed.

We would respectfully request that these two reports be treated as the Center's written testimony concerning the legislation and be included in any distributions of other organizations' written statements to members of Congress, their staffs, the news media, and the general public. Thank you for your consideration.

Sincerely,

Michael Mazerov

Michael Mazerov, Senior Fellow

Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

Updated February 26, 2014

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

By Michael Mazerov

A bill introduced in the U.S. House of Representatives would strip states and localities of their current authority to tax a fair share of the profits of many corporations that are based out-of-state but do business within their borders. It would reduce state and local governments' revenues by at least $2 billion in the very first year after enactment, impairing their ability to fund education, health care, public safety, and other essential services. Representative Jim Sensenbrenner reintroduced this bill, the "Business Activity Tax Simplification Act" ("BATSA"), H.R. 2992, on August 2, 2013. The House Judiciary Committee will hold a hearing on the bill on February 26.

BATSA defines many activities that corporations commonly conduct within a state as being no longer sufficient to obligate the corporation to pay several different kinds of taxes to the state (or to its local governments). Moreover, it defines these "safe harbors" from taxation in a highly ambiguous, arbitrary and inconsistent manner. These new restrictions on state and local taxing authority would have far-reaching, adverse impacts on the revenue-generating capacity and fairness of state and local tax systems. The most significantly affected taxes would be corporate income taxes levied by 44 states, the District of Columbia, and New York City. If enacted, BATSA would have the following effects:

- The legislation would cause state and local governments collectively to lose substantial tax payments from out-of-state corporations that would be freed from their current obligations to pay taxes on their profits and gross sales to particular jurisdictions. A significant share of currently-taxable corporate profits would go untaxed by *any* state, leading to a net revenue loss for the states as a whole. According to a Congressional Budget Office estimate done in 2011 on an identical version of the bill, state and local revenue losses would be $2 billion annually in the first full year after enactment and likely to grow in subsequent years.

  States have already suffered massive loss of revenues as a result of the recession and slow recovery. Additional loss of revenue in the next few years would undermine state funding for education, health care, public safety, infrastructure, and other services important for states' long-term prosperity.

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

- BATSA would stimulate a wave of new corporate tax sheltering activity aimed at cutting state and local business tax liabilities, which would stimulate demand for tax lawyers and accountants but reduce economic productivity and competitiveness.

- The legislation would mire state and local governments and corporations alike in a morass of litigation over whether particular businesses are or are not protected from taxation under the numerous vaguely-defined provisions of BATSA — another outcome that would benefit lawyers and accountants at the expense of everyone else.

- BATSA would reward major multistate corporations that have the resources to engage in aggressive tax-avoidance behavior with much lower tax burdens than their small, locally-oriented competitors, thereby handing small businesses a competitive disadvantage.

For example, if BATSA were enacted:

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

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

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

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

A compelling case for tighter federal limits on the authority of states to impose business activity taxes on out-of-state corporations has not been made. If, nonetheless, Congress decides to act in this area, workable and fair alternatives to BATSA are available. A proposed taxing jurisdiction (or "nexus") standard developed by the Multistate Tax Commission, for example, would base taxing authority on relatively objective measures of the dollar amount of a business' sales occurring in a state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.[1] Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a business activity tax on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

What Would BATSA Do?

BATSA would impose what is usually referred to as a federally-established "nexus" threshold for state (and local) BATs. State taxes on corporate profits are the most widely-levied state business activity taxes.[2] The term also encompasses such broad-based business taxes as the New Hampshire Business Enterprise Tax (a form of value-added tax), the Washington Business and Occupations Tax and the Ohio Commercial Activities Tax (both are taxes on businesses' gross sales), and the Texas Franchise Tax (a modified gross sales tax). The "nexus" threshold is the minimum amount of activity a business must have in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State business tax laws set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must file a tax return and pay any tax that may be due. Federal statutes can invalidate state nexus laws, however, and BATSA proposes to do just that.

BATSA proponents claim that the bill would impose a "bright-line," physical presence requirement for BAT nexus.[3] This claim implies that if a corporation has a physical presence in a state, it could be subjected to a BAT by that state. In reality, the bill would create a plethora of exceptions to a physical presence standard. Many types of clear and substantial physical presence in a state that establish nexus for a business under current state and federal law would no longer be sufficient to obligate the business to pay a BAT to the state. For example, a corporation would no longer have nexus in a state under BATSA even if it had dozens of employees in the state negotiating purchases of supplies for the business or a million dollars worth of inventory in the state being stored at a third-party warehouse for local delivery on demand to its customers. There is no question that such substantial physical presence in a state would establish BAT nexus for the corporation under current law.

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

- extending it to the entire service sector of the economy; and
- extending it from income taxes to all business activity taxes; and
- establishing numerous new "safe harbors" from nexus (while retaining the safe harbors for in-state solicitation and delivery). For example, under BATSA a corporation could have an unlimited number of employees or an unlimited amount of equipment or other property in a

state for up to (and including) 14 days per year without establishing BAT nexus.

(The Appendix to this report contains a more detailed discussion of the provisions of BATSA and the specific types of corporations and business activities it would exempt from state and local business activity taxes. The Appendix is available at http://www.cbpp.org/files/6-24-08sfp-appendix.pdf .)

Adverse Impacts of BATSA on State Finances and Corporate Tax Fairness

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

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

  - *Example.* A Maryland-based industrial equipment manufacturer takes its orders over the Internet but has nexus in every state in which it has customers because its employees install that equipment at its customers' place of business. Under BATSA, this manufacturer could easily arrange to have corporate income tax nexus only in Maryland. The bill provides that the use of an agent in a state does not create nexus so long as the agent has more than one client. The clients may be related to the agent through common ownership. The manufacturer could bring itself under this safe harbor by forming one subsidiary to employ the equipment installers and two others to manufacture the equipment (say, one subsidiary to manufacture Product A and another to manufacture Product B). Such a restructuring would make the installation subsidiary the agent of two legally-distinct manufacturer "clients." This would satisfy the terms of the "safe harbor" in BATSA and block all states except Maryland from taxing the corporation's profit from equipment sales. Because of how Maryland taxes the profits of multistate corporations, none of the corporation's profit earned on equipment sales made to non-Maryland customers would be taxable in Maryland, either — meaning that this corporation's total tax payments to the states taken together likely would drop precipitously.[4] Multiply this scenario by thousands of businesses in scores of states, and it becomes clear that the aggregate loss of state corporate income tax revenue would be substantial.

In 2011, the Congressional Budget Office estimated that the enactment of a version of BATSA that is identical to H.R. 2992 would have led to lost revenues for state and local governments that "would be about $2 billion in the first full year after enactment and at least that amount in subsequent years." CBO also observed: "Subsequently, corporations likely would rearrange their business activities to take advantage of beneficial tax treatments that would result from the interaction of the new federal law and certain state taxing regimes. Those changes in business activities would likely result in additional revenue losses to the states" beyond the $2 billion immediate impact.[5]

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

  - *Example.* A Massachusetts bank makes home mortgage loans to Connecticut borrowers who apply for the loans over the Internet or during an in-home visit by an independent mortgage broker engaged by the bank. The borrowers go to settlement at a Connecticut title company of their choice. BATSA would block Connecticut from taxing the bank's profits on those loans: the bank has no employees and owns no property in Connecticut, and its use of Connecticut brokers and settlement agents does not create nexus because the companies provide these services to multiple banks. Connecticut is barred from taxing any of the bank's profits on Connecticut home loans despite the fact that the banks use Connecticut's courts to foreclose on delinquent loans and the value of the homes that serve as mandatory collateral for the loans is crucially dependent on the quality of local schools, parks, roads, and police and fire protection provided by Connecticut and its local governments. Under provisions of Massachusetts' bank taxation law, Connecticut's inability to tax the bank likely would result in the bank's paying tax on profits from the Connecticut loans to Massachusetts instead.[6] Nonetheless, BATSA would deny Connecticut its fair share of tax on profits earned within its borders by a corporation that is benefiting from public services Connecticut provides to the bank, the bank's collateral, and the bank's in-state settlement agents.

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

  - *Example.* Under a tax shelter employing a so-called "intangible holding company" (IHC), a corporation operating retail stores like The Limited transfers its trademarks to a subsidiary corporation it has created in a tax-haven state like Delaware or Nevada. The stores then pay royalties to this subsidiary for the use of the trademarks. These royalties are tax-deductible (as a cost of doing business) and hence can be used to largely or entirely eliminate corporate income tax liability in the states in which the corporation is actually doing business and earning its profits.[7] Meanwhile, the royalty payments are not taxed by the tax-haven state. Almost three-fourths of the states with corporate income taxes seek to nullify this tax shelter by asserting that the IHC is directly taxable in any state from which it receives royalties.[8] BATSA would close off this avenue of attack on IHCs by providing that the presence in a state of an intangible asset like a trademark does not create BAT nexus for the out-of-state corporation that owns it. In so doing, BATSA would reverse court decisions in Louisiana, Maryland, Massachusetts, New Jersey, New Mexico, North Carolina, Oklahoma, and South Carolina that held that IHCs had nexus in those states, as well as repeal the nexus policy of some 25 additional states.[9]

(While states can amend their tax laws to implement alternative approaches to nullifying the IHC tax shelter, multistate corporations have blocked enactment or watered down such laws in many states.[10] In contrast, most states can assert nexus over the out-of-state owner of the trademark under their existing BAT nexus laws — laws which BATSA would invalidate.)

- *Opening up vast new tax-avoidance opportunities.* BATSA would open up enormous new opportunities for corporations to shelter their profits from taxation in states in which the profits are earned by dividing themselves into separate legal entities (such as a parent corporation and several subsidiary corporations). For example, the bill provides that a corporation can send an unlimited number of employees and an unlimited amount of equipment into a state without establishing BAT nexus so long as the employees and equipment are not in the state for more than 14 days in a calendar year. However, this 14-day limit — like all the "safe harbors" from nexus in BATSA — applies separately to every individual corporation in a multi-corporate group.

  - *Example.* A business providing on-site computer repair and troubleshooting services needs to have employees in a neighboring state an average of 180 days per year. However, it would like to avoid triggering BAT nexus in the neighboring state because the corporate tax rate in its home state is lower. The company could achieve both objectives with modest legal and accounting costs by incorporating 13 different subsidiaries to employ its repairmen and rotating responsibility for providing service in the neighboring state among those subsidiaries at 14 day intervals. If the company were too small to employ 13 repairmen, it could rotate their employment among the subsidiaries as well.

In a 2008 report, the Congressional Research Service concurred that the enactment of federal BAT nexus legislation like BATSA would lead to increased corporate tax avoidance:

> [BATSA] would increase opportunities for tax planning and thus tax avoidance and possibly evasion. In addition, expanding the *types* of activities that are covered by P.L. 86-272 would also expand the opportunities for tax planning.[11]

Adverse Impacts of BATSA on the Economy

Enactment of BATSA also would adversely affect the economy.

- *Degraded public services.* As noted above, the Congressional Budget Office has concluded that the enactment of BATSA would cause state and local governments to lose approximately $2 billion in annual revenues almost immediately and even more after corporations have an opportunity to restructure their operations to take advantage of the tax-sheltering opportunities the bill creates. By depriving states of business activity tax revenues they currently are collecting, the legislation could further impair their ability to provide services that are a critical foundation of a healthy national economy — such as high-quality K-12 and university education and transportation infrastructure.

- *Costly litigation.* The U.S. Supreme Court's 1992 *Quill* decision reaffirmed a 1967 decision that established "physical presence" as the nexus threshold for state *sales* taxes.[12] Far from being the "bright line" nexus standard sought by the Court, litigation on the meaning of "physical presence" has continued unabated since *Quill*.[13] BATSA not only would re-create these conflicts in the BAT arena, but it would also create new areas of litigation because it contains numerous ambiguous definitions whose meaning could only be resolved by courts. Given the substantial new limitations placed on their revenue-raising ability by BATSA, states and localities would have no choice but to engage in widespread litigation aimed at establishing the narrowest-possible interpretation of the nexus "safe harbors" contained in the law. Such litigation would waste the limited financial and human resources of taxpayers and tax administrators alike.

- *Example.* BATSA provides that having employees or property in a state in order to conduct "limited or transient business activity" does not create nexus. Neither "limited" nor "transient" is defined in BATSA. An exemption for "limited" activity could imply that a business will not be taxable in a state if it does not engage in the full range of activities involved in its business; for example, a manufacturer might not be taxable in a state in which it had a sales office but not one of its manufacturing plants. An exemption for "transient" presence means that a business might never be taxable in a state its employees entered temporarily no matter how many days per year they spent there. Given this ambiguity and the enormous revenue consequences for the states flowing from how just these two terms in BATSA might be interpreted, their enactment into law would be a prescription for constant litigation until the Supreme Court supplied some measure of clarity. In the case of the meaning of the term "solicitation" in P.L. 86-272, that was a period of more than *30 years*.

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

> [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[14]

- *Example.* Jeff Bezos, the CEO of Amazon.com, has acknowledged that he would have preferred to establish his company in California rather than Washington but did not do so in order to avoid having to charge sales tax to the large customer market located in California.[15] Had Amazon.com been obligated to charge sales tax to California customers regardless of whether it was physically present in that state, Bezos would not have had an incentive to establish the company in a less-than-ideal location. A physical presence nexus threshold for BATs could create the analogous incentive for economically sub-optimal location decisions.

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

  - *Example.* A multistate bookstore chain places computer kiosks in all its stores. The kiosks are linked to its World Wide Web operation. Store employees help customers place orders for books not available in the store at the kiosks. The stores advertise the address of the Web site in all their advertising. The stores even accept returns of unwanted books purchased at the Web site. Despite this critical sales assistance provided by the stores to the online operation, under BATSA the Web operation could easily avoid having to pay tax on its profit to any state(s) except the one(s) where it has offices, warehouses, or similar facilities.[16] The owner of a local independent bookstore, on the other hand, lacking the resources to set up an out-of-state electronic commerce Web site and distribution facility, would have 100 percent of his profit subject to taxation by the state in which the store is located.

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

We live at a time when the combination of the Internet, inexpensive interstate transportation, and widely available consumer credit often enables even the smallest of businesses to tap into the market of distant states far more successfully, efficiently, and profitably than a horde of traveling salespeople could hope to do. Because of the vast expansion of interstate sales that has been sparked by the development of electronic commerce, there seems to be a growing realization that the "physical presence" nexus threshold for the imposition of state *sales* taxes established by the U.S. Supreme Court's 1992 *Quill* decision makes little sense. Indeed, many trade associations supporting BATSA are on record supporting federal legislation reversing the *Quill* decision.[17]

Thus, it is inconsistent for the supporters of BATSA now to propose permanently enshrining substantial in-state "physical presence" as the threshold for the imposition of state business activity taxes. And it is incorrect for them to characterize this as a "modernization" of P.L. 86-272. Given the numerous organizational strategies and technologies corporations can now employ to make substantial sales and earn substantial profits in a state without actually being physically present within its borders, it is clear that a physical presence nexus threshold is obsolete and unfair. It really cannot be argued seriously that states should be barred from taxing the profits of a corporation like Pizza Hut because it chooses to franchise its ubiquitous restaurants rather than own them directly. That is the kind of step backward in tax policy that BATSA would implement.

BATSA: An Internally Inconsistent Nexus Policy Designed to Favor Large Multistate Corporations

Proponents of federal BAT nexus legislation have stated time and again that the fundamental principle underlying the bill is that corporations do not benefit from public services in states in which they do not have a physical presence and therefore should not be required to pay a BAT to such a state.[18] Even assuming for the sake of argument that this indefensible principle were valid, it is clear that the bill as actually drafted does not reflect it — nor any other rational balancing of benefits received by businesses from public services and the businesses' obligation to support those services through the payment of taxes.

A principle that says that businesses should not be subject to tax in a state in which they lack a physical presence because they obtain no benefits from government services cannot be squared with a bill that allows corporations to have massive — indeed unlimited — amounts of several types of employees, property, representatives, and agents present within a state without establishing BAT nexus. Nor can the principle be squared with a bill that bars a state from imposing an income tax on a corporation that has 100 people in the state for 14 days in a particular year but allows the state to tax a business that has only a single employee in the state for 15 days. Clearly, the former business is likely to be benefiting more from state-provided services than is the latter.

Contrary to the claim of its proponents, what is on display in BATSA is not implementation of the principle that no physical presence equals no benefits from public services equals no obligation to pay taxes to support those services. Rather, BATSA is simply a "grab bag" of nexus "safe harbors" that the corporations lobbying for it would benefit from and think they may have sufficient clout to get through Congress. It is easy to discern the motives of many corporations that have publicly supported BATSA in the past — and presumably still do.[19] For example:

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

- A corporation like General Electric would likely benefit from a new safe harbor from nexus for any activities conducted in a state for up to 14 days by its employees or for an unlimited amount of time by one of its own subsidiaries.[20] Presumably many G.E. products, such as medical imaging equipment, are complex and often require on-site installation or trouble-shooting assistance from G.E. employees — a post-sale activity not currently protected by P.L. 86-272.

- BATSA would benefit corporations like The Limited and The Gap, which have been sued by multiple states claiming that their trademark holding companies had nexus in those states. As explained above, BATSA would put an end to such litigation in the future and hinder state efforts to shut down this tax shelter.

- A company like UPS, which operates warehouses in which independent companies like Internet retailers store their inventory for quick delivery to customers, would benefit from a new safe harbor that provides that nexus is not created by the use of such third-party "fulfillment" services. Although the wording of BATSA is vague, this provision would be meaningless if it did not also encompass a nexus safe harbor for the storage of the retailer's inventory in the warehouse — which it presumably is intended to allow.

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

Rational and Fair Alternatives to BATSA Are Available

BATSA proponents have failed to make a convincing case for its enactment.[21] But if Congress nonetheless feels compelled to intervene in this area, workable and fair alternatives to BATSA are available. A proposed nexus standard developed by the Multistate Tax Commission, for example, would base the creation of nexus on relatively objective measures of the dollar amount of a business' sales occurring in a state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.[22] Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a business activity tax on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

A nexus threshold based on the volume of sales in a state can achieve this balancing of tax compliance costs and tax liability in a direct, administrable manner. Reasonable people can disagree about what the threshold should be. If business and state and local government representatives are unable to agree, Congress can be the final arbiter — just as Congress would be in proposed legislation establishing a sales-based nexus threshold for sales taxation. The "Marketplace Fairness Act" (S. 743/S. 336/H.R. 684) would empower any state adopting a prescribed set of measures aimed at simplifying its sales tax to require a non-physically present retailer to collect the state's sales tax if the seller has more than $1 million in nationwide sales.

Qualitative nexus thresholds that look to the type of activities occurring in the state and/or the relationships between in-state and out-of-state entities inherently create irrational and conflict-ridden tax policy. Public Law 86-272 itself demonstrates this. A corporation earning millions of dollars of profit in a state in which scores of its employees are continuously soliciting sales and dozens of its vehicles are continuously plying the roads loaded with millions of dollars worth of goods does not have income tax nexus under P.L. 86-272. At the same time, a small out-of-state retailer who sends employees into the state just twice each month to assemble a swing-set in someone's back yard for a few hundred dollars in profit *can* be required to pay an income tax to the state. Such disparate results cannot possibly be characterized as "rational and fair taxation."[23]

If Congress is determined to act in this area, a better approach would be to repeal P.L. 86-272 and substitute a nexus threshold based entirely on objective, quantitative measures of in-state business presence and activities. The $1 million sales threshold in the current version of the Marketplace Fairness Act or the Multistate Tax Commission's "factor presence" nexus standard (which looks to the dollar amount of property, payroll, or sales located in a state) would be good starting points for congressional consideration.

Notes

[1] See: Multistate Tax Commission, "Factor Presence Nexus Standard for Business Activity Taxes," October 17, 2002. Available at www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

[2] Corporate income taxes are levied by 44 states, the District of Columbia, and New York City. In 2011 these taxes supplied almost $49 billion to state and local treasuries.

[3] "A bright-line, physical-presence nexus standard would reduce the likelihood that companies will be targeted by out-of-state tax authorities bent on raising revenues from businesses that do not have a presence in their state." Coalition for Interstate Tax Fairness and Job Growth, "Coalition Response to Multistate Tax Commission's Attack on BATSA," June 7, 2012. The Coalition is a group of major multistate corporations organized to lobby for BATSA's enactment.

[4] Like more than twenty other states, Maryland taxes the profits of multistate manufacturers only in proportion to their sales to Maryland customers. Accordingly, a Maryland-based manufacturer with no customers in Maryland would pay no corporate income tax to the state. Moreover, like roughly half the states, Maryland has not enacted a "throwback rule" to subject to taxation the profits earned by a Maryland manufacturer in other states in which the manufacturer has not established nexus. As a result of the combination of these two corporate income tax "apportionment" policies, the lion's share of the nationwide profit of a Maryland manufacturer that was protected from taxation in other states by BATSA would be "nowhere income" — profit that would not be taxed by any state. The interaction between BATSA and rules like those of Maryland that base corporate income tax liability on in-state sales alone are discussed in a separate Center report. See: Michael Mazerov, *Federal "Business Activity Tax Nexus" Legislation: Half of a Two-Pronged Strategy to Cut State Corporate Income Taxes*, Center on Budget and Policy Priorities, revised May 13, 2011.

[5] CBO Cost Estimate for H.R. 1439, September 13, 2011, available at http://www.cbo.gov/sites/default/files/cbofiles/attachments/hr1439_2.pdf .

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

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

> "For a glimpse into this quiet and lucrative world, head up to the 13th floor of 1105 N. Market St.. Through smoked-glass windows, a visitor can view the high-rise headquarters surrounding Wilmington's prestigious Rodney Square: DuPont and Hercules, Wilmington Trust and MBNA. But turn back, and look inside this slender office tower. Tucked within the building's stark, upper floors, is another, hidden corporate center. Here, more than 700 corporate headquarters make up a vast and quiet business district of their own. The lobby computer lists their names: Shell and Seagram and Sumitomo, Colgate-Palmolive and Columbia Hospitals and Comcast, British Airways and Ikea, Pepsico and Nabisco, General Electric and the Hard Rock Cafe. How do 700 corporate headquarters squeeze into five narrow floors? How do 500 fit on the 13th floor alone? "Frankly, it's none of your business," said Sonja Allen, part of the staff that runs this corporate center for Wilmington Trust Corp. . . ." "Some of my clients are saving over $1 million a month, and all they've done is bought the Delaware address," said Nancy Descano, holding company chief of CSC Networks outside Wilmington."

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

[8] John C. Healy and Michael S. Schadewald, 2013 *Multistate Corporate Tax Guide*, "Activities Creating Franchise or Income Tax Nexus (Part 1)," CCH, Volume 1, pp. 2019-2026.

[9] The Maryland case upheld the state's authority to require the intangible holding company of the Syms clothing chain to pay Maryland corporate income tax on the royalties it earned by licensing use of the Syms trademark to Maryland Syms stores. The analogous cases in the other states named involved Kmart, The Limited, The Gap, and Toys R Us. In addition, the West Virginia Supreme Court upheld the authority of that state to impose its corporate income tax on an out-of-state bank issuing credit cards by mail to state residents.

[10] Bills to implement one major anti-IHC mechanism, "combined reporting," have been introduced since 2000 in the District of Columbia and 22 states: Alabama, Arkansas, Connecticut, Florida, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Missouri, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, Virginia, West Virginia and Wisconsin. Combined reporting was enacted in the District and in 7 of the 22 states: Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin. Bills denying an income tax deduction for royalty payments to IHCs have been introduced since 2000 in at least 15 states that have not enacted combined reporting: Alabama, Arkansas, Connecticut, Georgia, Indiana, Kentucky, Maryland, Mississippi, Missouri, New Jersey, North Carolina, Pennsylvania, Rhode Island, Tennessee, and Virginia. They were not enacted in two of them: Missouri and Tennessee. In most of the other 13 states the bills were so watered down with numerous exceptions after intense business lobbying that they arguably will be largely ineffectual against IHCs. (See: Charles F. Barnwell, Jr., "Addback: It's Payback Time," State Tax Notes, November 17, 2008.) In short, despite the serious fiscal problems of the states in the recent years, the business community has had a decent track record in blocking the two approaches to shutting down the IHC tax shelter that require state legislative action.

Moreover, H.R. 2992 contains a provision that will substantially undermine the ability of combined reporting to nullify IHCs. The language will bar combined reporting states from assigning royalties received by IHCs to the states in which the trademark is used. This will result in a substantial revenue loss for many combined reporting states.

[11] Steven Maguire, *State Corporate Income Taxes: A Description and Analysis*, Congressional Research Service, updated June 25, 2008.

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

[13] The U.S. Supreme Court's stated goal in its 1992 *Quill* decision was to establish a "bright line" physical presence nexus threshold for state imposition of *sales* taxes. Surveying the widespread sales tax nexus litigation that had occurred in just the first few years subsequent to *Quill*, a leading expert on Internet tax-related issues stated flatly: "The current physical-presence standard for sales and use tax nexus has not created a bright-line test but instead has resulted in jurisdictional rules that are frequently ambiguous and inconsistent." (Karl Frieden, *Cybertaxation* (Arthur Anderson/CCH, Inc.), 2000, p. 356.) A leading law firm that litigates nexus cases for corporations concurred: "While . . . [*Quill's*] 'bright line' [physical presence] rule was intended to bring clarity to the boundaries of legitimate state authority to impose an obligation to collect sales and use taxes, and to 'encourage settled expectations,' it has not produced the hoped-for certainty." (Troy M. Van Dongen, "Internet Retailers under Fire: *Borders Online* Exemplifies the Predicament." Online newsletter of the Morrison & Foerster law firm, July 2002.) There have been numerous sales tax nexus cases in recent years. Amazon.com and Overstock.com, for example, recently lost challenges to an expanded nexus law in New York that they had pursued for more than five years.

[14] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001.

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

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

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

[16] BATSA provides that "using the services of an agent (excluding an employee)" in a state on more than 14 days "to establish or maintain the market in the State" creates nexus for the out-of-state business using the in-state agent, but only if "such agent does not perform business services in the State for any other person during such taxable year." There is nothing in the legislation that requires the "other person" to be an independent third party. The Web-based bookselling operation could easily bring itself under this safe harbor by incorporating two nominally-distinct subsidiaries, for example, one selling books and the other selling all other types of merchandise (greeting cards and calendars, for example). Because the store personnel (who are not employees of the Web site) would be helping "to establish or maintain the market" for two "other persons" — the subsidiary that sells books and the subsidiary selling other items — nexus would not be created for the Web operation by the activity of the stores' employees. As long as customers of the Web operation are nominally buying books and other goods from two different companies, the Web operation can avoid creating nexus in the states where the retail stores are located. The two Web stores could easily contract to share the same Web site and warehouses; no change in physical operations would be necessary.

[17] For example, the Council on State Taxation and the National Retail Federation are active supporters of proposed federal legislation reversing *Quill*.

[18] "The underlying principle of this legislation is that states and localities that provide meaningful benefits and protections to a business, like education, roads, fire and police protection, water, sewers, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, H.R. 1956 ensures that the economic burden of state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state." Written testimony of Arthur R. Rosen in support of H.R. 1956, Subcommittee on Commercial and Administrative Law, House Judiciary Committee, September 27, 2005. H.R. 1956 was the version of BATSA introduced in the 109th Congress.

[19] The membership of the Coalition for Interstate Tax Fairness and Job Growth, which was organized to lobby for BATSA's enactment, is available at http://www.interstatetaxfairness.com/who-we-are/. All of the corporations listed in the following bullets are listed as current members of the Coalition.

[20] Recall again that a corporation can use a subsidiary to conduct activities on its behalf in another state for an unlimited number of days in a year without thereby establishing nexus so long as the subsidiary works for at least one other subsidiary. See Note 16.

[21] See: Michael Mazerov, "Proponents' Case for a Federally-Imposed Business Activity Tax Nexus Threshold Has Little Merit," Center on Budget and Policy Priorities, February 26, 2014; http://www.cbpp.org/files/6-26-08sfp.pdf .

[22] See the source cited in Note 1.

[23] A business coalition lobbying in support of previous versions of BATSA was known as the "Coalition for Rational and Fair Taxation." See www.batsa.org.

Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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PROPONENTS' CASE FOR A FEDERALLY-IMPOSED BUSINESS ACTIVITY TAX NEXUS THRESHOLD HAS LITTLE MERIT

By Michael Mazerov

A bill under consideration in the U.S. House of Representatives would strip states of their current authority to tax a fair share of the profits of many corporations that are based out-of-state but do business within their borders. The House Judiciary Committee will hold a hearing on the "Business Activity Tax Simplification Act of 2013," ("BATSA", H.R. 2992) on February 26. This Center report rebuts the arguments offered by BATSA proponents in support of the legislation.

BATSA would impose what is usually referred to as a federally-mandated "nexus" threshold for state (and local) "business activity taxes" (BATs). State taxes on corporate profits are the most widely-levied state business activity taxes. The term also encompasses such broad-based business taxes as the New Hampshire Business Enterprise Tax (a form of value-added tax), the Texas Franchise Tax (a tax on businesses' "gross margins"), and the Washington Business and Occupation Tax and the Ohio Commercial Activities Tax (both are taxes on businesses' gross sales). The "nexus" threshold is the minimum amount of activity a business must conduct in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State business tax laws will set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must file a tax return and pay any tax that is owed. Federal statutes can override state nexus laws, however, and BATSA proposes to do just that. BATSA would create a number of new nexus "safe harbors" — categories and quantities of activities conducted by corporations in states that would be deemed no longer sufficient to establish BAT nexus for the corporation.

A companion Center on Budget and Policy Priorities report provides an overview and analysis of the proposed legislation. (See: "Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy," updated February 26, 2014. Hereafter referred to as the "Center's analysis of BATSA.") That report focuses on the adverse impact of BATSA on the revenue-raising capacity and fairness of state corporate income taxes.

This report has a different objective: to rebut the key claims made by the proponents of BATSA as to why its enactment is necessary. (Readers unfamiliar with the business activity tax nexus issue may find this report more useful if they have already read the previous Center analysis of BATSA.) This report will demonstrate that the sometimes reasonable-sounding arguments offered in support of the legislation actually have little merit and are mainly a smokescreen to obscure the corporations' straightforward goal of cutting their state tax payments.

The following are the key arguments offered in support of the enactment of BATSA, paired with rebuttals.

General Claims about Why the Bill Is Needed

Claim:

BATSA establishes a "physical presence" nexus threshold for state BATs. Such a threshold is fair, because businesses don't benefit from public services to any meaningful extent in states in which they don't have employees or facilities and therefore shouldn't be obligated to pay any BAT to such a state.

Rebuttal:

- BATSA does *not* establish a "physical presence" nexus threshold. A true "physical presence" nexus standard would provide that a corporation that has employees or property in a state is taxable there and a corporation that is not physically present is not taxable. In actuality, BATSA would allow corporations to have *unlimited* amounts of several categories of employees, agents, and property in a state without establishing nexus for business activity taxes. For example, the bill would allow a corporation to have an unlimited number of salespeople in a state using company-owned computers and driving company-owned cars without creating BAT nexus, as long as the salespeople worked out of their homes or visited from out of state.

- Such employees and property are clearly benefiting from state-provided services like roads and police protection, negating the fundamental rationale offered for BATSA.

- Out-of-state businesses often benefit substantially from public services provided by states in which they have no physical presence but do have customers, and can reasonably be expected to pay some amount of business activity tax to such a state. For example, when an out-of-state bank makes mortgage loans in a state, the value of the houses that serve as collateral on the loans depends critically on the quality of local schools where the home is located, and the collateral itself is protected by local police and fire services. Moreover, banks use the local court system to foreclose on the loans if borrowers don't repay. The provision of such services justifies the payment of some income tax by the bank to the states where its borrowers are located, notwithstanding its lack of a physical presence in such states.

- In most states the *amount* of income tax a corporation owes substantially depends on the amount of physical presence the corporation has in the state; the more employees and property, the higher the tax payment. That is appropriate under the "benefits received" principle of taxation, because businesses are likely to benefit more from public services the more workers and property they have in a state. But to suggest that a non-physically-present business should have *no* tax obligation to the state is unreasonable given the fact that it is earning income in the state and benefiting from services provided by the state.[1]

- In its 1992 *Quill* decision, the U.S. Supreme Court said explicitly that a non-physically-present mail-order company that purposefully availed itself of a consumer market in North Dakota *was* benefiting sufficiently from public services provided by that state to be fairly required to collect and remit sales taxes to that state. The fact that the decision nonetheless upheld a "physical presence" nexus threshold for sales taxes was based on the court's desire to protect interstate commerce generally from excessive sales tax *compliance* burdens, not on the grounds of unfairness to the Quill Corporation itself.

Claim:

BATSA is needed to "codify" federal and state court decisions that strongly imply that "physical presence" is the nexus threshold for BATs under the U.S. Constitution, because a small number of recalcitrant, aggressive states refuse to accept the clear message being sent by the courts.

Rebuttal:

- Two U.S. Supreme Court cases, *Whitney* v. *Graves* (1937) and *International Harvester* (1944) make clear that a person or business that receives income that has a source in a particular state need not be physically present in that state for the state to tax the income. Perhaps with these cases in mind, the U.S. Supreme Court stated in its 1992 *Quill* decision: "[W]e have not, in our review of other types of taxes, articulated the same physical-presence [nexus] requirement . . . established for sales and use taxes."[2]

- State courts are split on whether a state can impose a BAT on a non-physically-present business, but at this point in time 12 state courts have held that they can and only two have held that they can't.[3] Moreover, five recent cases that sided with the states' position that physical presence is *not* required for BAT nexus were appealed to the U.S. Supreme Court, and in each case the Court declined to review the decision.[4]

Claim:

BATSA is needed to reverse those state court decisions that have held that physical presence is not required for BAT nexus, because they likely were wrongly decided. In the 1992 *Quill* decision, the U.S. Supreme Court held that an out-of-state business must be physically present in a state before it can be required to collect and remit sales tax to that state. Logic demands that the nexus threshold for BATs be *at least* "physical presence," because a BAT is imposed directly on the business and comes out of the business' pocket, while a sales tax is merely collected from the customer by the business.

Rebuttal:

- As explained above, the "physical presence" nexus threshold established in *Quill* was based on the Court's desire to protect interstate commerce from excessive sales tax *compliance* burdens, not on any concerns about the *economic* burden on the company itself. Sales taxes have a much greater potential to interfere with a business' engaging in interstate commerce than corporate income taxes and other BATs do, because a company that is obligated to collect sales taxes from customers on behalf of a state must engage in numerous activities before it makes a single sale. For example, it must register as a sales tax collector, it must identify every one of its products and its customers as taxable or tax-exempt, it must program its accounting system to charge its taxable customers the proper tax, and it must actually collect the tax from them and maintain records to demonstrate to an auditor that it has done so. In contrast, the only thing a company must do to comply with a BAT is properly fill out its tax return based on its general books and records. Given the greater burdens of sales tax compliance as compared to BAT compliance, one could reasonably argue that it is appropriate to have a *higher* nexus threshold for a sales tax than for an income tax or other BAT.

- It could also be argued that the sales tax nexus threshold should be higher than the BAT threshold because in the case of the sales tax a business is being "drafted" to collect a tax that is actually owed by the purchaser and that the state would be capable of collecting directly from the purchaser (with sufficiently intrusive auditing). In contrast, a BAT is the legal liability of the business being asked to pay it; there is no other party from whom the tax could be collected. (One could not reasonably ask the in-state purchaser to estimate the *profit* earned on her purchase and send the tax due on it to the home-state tax agency rather than to the seller.) Thus, if states are to have the right to tax income earned within their borders by individuals and businesses alike (and no one proposes that they be stripped of this long-established right), and if businesses are capable of earning such income without being physically present (which they are), it is illogical for states to be barred from taxing that income merely because the business is not physically present within the state.

Claim:

The principles of federalism embodied in the U.S. Constitution, which vests in Congress the authority to regulate interstate commerce, demand that Congress enact legislation to establish a uniform national BAT nexus standard.

Rebuttal:

- No one questions the authority of Congress to enact BATSA; the debate is over the wisdom of its doing so.

- "Federalism" is not merely about the mechanical division of authority between the federal government and the states. Its principles also encompass notions of deference and comity toward states on the part of the federal government. State and local governments are partners with the federal government in providing essential government services like education, health care, and transportation, which they cannot provide if their powers of taxation are unduly and unnecessarily interfered with. Congress has enacted several laws limiting state taxing powers that have spawned substantial, costly litigation and led to adverse unanticipated consequences for states because Congress did not take adequate care in drafting them. BATSA has the potential for many such problems. Congress should therefore give great deference to state tax policies absent a compelling showing that they are contrary to the national interest.

- Federalism is often justified as a means of keeping government "close to the people" so that elected officials can be held accountable to citizens. Federal preemption of state taxing powers violates this goal, because it enables Congress to provide tax cuts to business interests at state expense with no accountability for any adverse consequences that result. It will be state officials, not members of Congress, who will be blamed if public services are reduced or household taxes are increased to compensate for tax cuts that have been provided to businesses by BATSA. Thus, the enactment of BATSA would undermine a key objective of federalism.

Claim:

BATSA is needed to stop states from asserting that they have the right to tax corporations that do no production within their borders but merely have customers there. Such a position is illegitimate because corporations earn income only where they produce goods and services, not where they sell them.

Rebuttal:

- The corporate income tax laws of virtually all states incorporate provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was promulgated in 1957 as a model state law for dividing corporate profits among the states for tax purposes. UDITPA was developed in a joint business-state task force, and it explicitly recognized making sales as an activity that contributes to the generation of business profit. Thus, in making the above claim, BATSA proponents are seeking to deny the existence of and reverse a 50-year-old consensus between the business community and state tax officials concerning where profits are earned.

- Much more recently, in the early 1990s, the Multistate Tax Commission (a joint agency of state tax departments), developed model rules aimed at clarifying where profits from such services as banking, publishing, and radio and TV broadcasting should be deemed to be earned. The traditional rules had assigned such income to the states in which the production of those services occurred. The new rules developed by the MTC assign that income to a much greater extent to the states in which the customers of those businesses are located. Several corporations playing a prominent role in lobbying for BATSA *supported* the adoption of the new MTC rules covering their industries.[5] Thus, the claim that "corporations only earn income where they produce, not where they sell" is completely inconsistent with the explicit position taken by many of the bill's proponents as recently as 15-20 years ago.

- Many corporations supporting BATSA have actively worked to enact legislation at the state level that is based on the premise that corporations earn profits *only* in the states in which they sell, and *not at all* in the states in which they produce (see: www.cbpp.org/1-26-05sfp.htm).

Claim:

Under international tax treaties that apply to *national* corporate income taxes, the nexus threshold for multinational corporations being taxable in another *country* is a "permanent establishment" (PE), that is, a brick-and-mortar facility. This is a further demonstration that the "physical presence" standard that BATSA would implement is an international norm for corporate income tax nexus.

Rebuttal:

- The PE threshold is part of a U.S. international tax structure that is completely different from the structure of state corporate income taxes and therefore is irrelevant to the nexus rules that should apply to multistate corporations. For example, since U.S.-based corporations are subject to tax on their worldwide incomes, PE rules affect only *where* a U.S. corporation's profits are taxed, not *if* they are taxed. In contrast, if a federal nexus law blocks a state in which a corporation has customers but no direct physical presence from taxing that corporation, a significant share of that corporation's profit is likely to be completely untaxed by any state. (See: www.cbpp.org/12-13-05tax.htm.)

- There are a significant number of policymakers who question the continued appropriateness of the PE standard for national-level corporate income taxes.[6] For example, a recent report of an Organization for Economic Cooperation and Development task force noted: "An enterprise now has the ability to electronically project a business presence to almost any corner of the globe and to deliver many products and services electronically. Enterprises no longer need to establish branch offices, staffed with people who can provide local services or face-to-face contact, in each of its major markets. The need for a human presence (and supporting physical infrastructure) in diverse locations may be much reduced. *In these circumstances, these [task force] members questioned whether a taxing threshold built on physical presence of an enterprise remains appropriate.*" [Emphasis added.] The fact that the task force recommended no change in the PE rules was attributable to its inability to agree on an alternative likely to be widely adopted, not on a consensus that the PE rules themselves remain correct.[7]

Claims About the Need for Specific Provisions of the Bill

Claim:

BATSA contains reasonable "safe harbors" that allow a corporation to have a "de minimis" amount of physical presence in a state before establishing nexus. The provision of BATSA that allows a corporation to have employees or property in the state for up to 14 days in a tax year without creating nexus is such a reasonable "de minimis" threshold.

Rebuttal:

- The 14-day safe harbor is completely inconsistent with the underlying rationale for BATSA, which is that a corporation's tax obligations to a state should be balanced with the benefits it receives from public services provided by the state. For example, BATSA immunizes a corporation with 100 employees in a state for 14 days from all BATs, while a corporation with just one employee in the state for 15 days could be required by a state to pay the BAT. Clearly, the first corporation is benefiting more from police, fire, transportation, and other services provided to its employees than is the second corporation, and yet it is the first corporation that BATSA exempts from taxation.

- The other safe harbors in BATSA are just as illogical and inconsistent with the fundamental rationale offered for the bill. For example, having a million dollar's worth of inventory in a state that is being stored at an order-fulfillment warehouse run by a business like UPS or Federal Express does not create nexus under BATSA, but owning a building in the state that is worth a million dollars does create nexus. There is no reason to believe that the value of police and fire protection being provided to both types of property is any different, yet one type of property creates nexus under BATSA and the other doesn't.

Claim:

Public Law 86-272 was enacted by Congress in 1959 and decrees that a state may not impose a corporate income tax on an out-of-state business whose only activity within the state is soliciting sales of tangible goods (including through the use of a traveling salesforce), if the orders are fulfilled from an out-of-state shipment point. BATSA is needed to "modernize" P.L. 86-272 by extending it to all BATs and to sales of services in addition to sales of goods.

Rebuttal:

- P.L. 86-272 was intended to be a temporary measure to hold a 1959 Supreme Court decision in abeyance. That decision signaled the end of a now completely discarded Supreme Court doctrine holding that states couldn't tax interstate commerce at all. P.L. 86-272 is an obsolete nexus law that violates the core rationale offered for BATSA: that only physically-present businesses should be subject to a BAT because only such businesses benefit from public services. P.L. 86-272 violates this principle because it allows a corporation to have an unlimited number of salespeople in a state and an unlimited amount of goods en route to customers in an unlimited number of company-owned trucks and yet still not create corporate income tax nexus. P.L. 86-272 should be repealed, not broadened, even under a true "physical presence" nexus standard. Its extension to sales of services and other BATs would be the opposite of "modernization."

- Extending P.L. 86-272 to the sale of services would be problematic and likely to spawn considerable litigation. In the case of a sale of goods, it is possible to draw the line between in-state solicitation of an order and fulfillment of the order from an out-of-state origination point with reasonable objectivity. That will not be true with the sale of services in many instances. For example, if a credit card holder uses her card to borrow cash from an out-of-state bank at an in-state ATM machine, is the service "fulfilled" in-state where the cash is delivered (which the state is likely to assert) or out-of-state at the credit card company's computer server that electronically "authorizes" the loan (which the bank is likely to assert)? Costly litigation will have to resolve many such questions if BATSA extends P.L. 86-272 to sellers of services.

Claim:

Many states take the position that if a corporation engages in solicitation or other market-enhancing activity within its borders on behalf of an out-of-state corporation, that creates nexus for the out-of-state corporation. BATSA is needed to stop states from aggressively and unfairly seeking to "attribute" nexus from one corporation to another in this manner. "Attributional nexus" is unfair and unreasonable because the state can tax the income of the in-state corporation and shouldn't be allowed to tax the income of the out-of-state corporation as well. Therefore, BATSA appropriately provides that the "market-creating" and "market-maintaining" activities of an in-state agent never establish nexus for the out-of-state company on whose behalf the agent is working if the agent represents at least two different clients.

Rebuttal:

- The U.S. Supreme Court upheld the fairness of "attributional nexus" for BATs in a decision issued more than 25 years ago.[8] In an even earlier sales tax nexus case, the Court observed that allowing a corporation to avoid nexus in a state by having "independent contractors" act on its behalf rather than using its own employees "would open the gates to a stampede of tax avoidance."

- The provision of BATSA blocking "attributional nexus" seeks to undermine the fundamental and longstanding operation of state corporate income taxes. Such taxes do not seek to divide marketing activities conducted in one state from production activities conducted in another. Rather, once a manufacturer (for example) establishes nexus in a state, that state taxes an apportioned share of the nationwide activities of the business, from the purchase of raw materials up to and including the final sale of the product to the ultimate customer. Under such a system, it makes no sense to bar a state from being able to tax a share of the profit earned from the manufacturing activities merely because the in-state marketing activities were conducted by a third party rather than the manufacturer's own employees. Even worse, under BATSA the "market-creating" activities could be conducted by a wholly-owned and controlled subsidiary of the manufacturer and not create nexus for the latter, if the goods were produced by two nominally separate subsidiary corporations. (See page 4 of the Center's analysis of BATSA.)

Claims about Alleged Harms that the Enactment of BATSA Will Stop

Claim:

By establishing a clear, nationally-applicable, physical-presence nexus standard, BATSA will substantially reduce the amount of nexus-related litigation that is occurring.

Rebuttal:

- BATSA contains numerous undefined terms that will generate considerable litigation, just as P.L. 86-272 has generated — and continues to generate — substantial litigation. For example, BATSA includes a provision declaring that nexus is not created by the in-state "conduct [of] limited or transient business activity" with no definition of "limited" or "transient." Because Congress failed to define the key "safe harbor" provision in P.L. 86-272 — "solicitation" — constant litigation occurred for more than 30 years until the U.S. Supreme Court accepted a case that offered some (minimal) guidance. BATSA will generate even more litigation than P.L. 86-272 did, because it is a much more far-reaching and complex bill.

- A comprehensive law review article documented 57 reported court cases involving disputes over the application of P.L. 86-272 as of 2003, and occasional cases have occurred since.[9] BATSA proponents can cite approximately 20 BAT nexus cases that do not involve P.L. 86-272.[10] Thus, the claim of BATSA proponents that "Public Law 86-272 has generated relatively few cases, perhaps a score or two . . . [while] areas outside its coverage have been litigated extensively" is false.

- As documented in the Center's analysis of BATSA, enactment of the bill will open up enormous opportunities for corporations to shelter their profits from taxation in many of the states in which they are earned. As a result, states will have no alternative but to use every legal means at their disposal to protect their tax bases. BATSA therefore will not reduce litigation between states and taxpayers, but — at best — merely displace it from nexus cases to cases challenging the use of these "fallback" approaches. For example, many states have discretionary authority to treat in-state and out-of-state subsidiaries for tax purposes as if they are one corporation but rarely use it because its exercise is almost always challenged in court. Because of the damage that will be done by BATSA to their revenues, states are more likely to use this discretionary "combined reporting" authority, with additional litigation resulting.

- The enactment of BATSA will not bring nationwide uniformity to nexus law. BATSA's provisions will be interpreted by state courts and, just as occurred under P.L. 86-272, state courts will reach different conclusions about what the provisions mean. Only a U.S. Supreme Court decision interpreting BATSA can provide a measure of national nexus law uniformity, and in the more than 50 year history of P.L. 86-272, the Court has accepted a single appeal from a state P.L. 86-272 case of general applicability.[11]

Claim:

BATSA is needed to prevent "double taxation" of corporate income, which is burdening corporations and stifling commerce.

Rebuttal:

- Proponents of BATSA have not provided any concrete examples of corporations subject to double taxation of their income. In fact, as explained in another Center report, BATSA is likely to have just the opposite effect, vastly increasing the share of U.S. corporate profit that is "nowhere income" not subject to tax by *any* state. (See: http://www.cbpp.org/files/1-26-05sfp.pdf)

- Restricting state taxing jurisdiction is an unnecessary and excessive mechanism for preventing double taxation of corporate income in any case. The potential for such double taxation can be substantially eliminated by states adopting uniform "apportionment" rules governing the division among the states of the profits of multistate corporations. Yet as documented in the report cited in the previous paragraph, many BATSA proponents have been instrumental in pushing states toward non-uniformity in their apportionment rules. In short, offering "double taxation" as a justification for BATSA is both unsupported by facts and hypocritical.

Claim:

BATSA is needed to prevent "taxation without representation." Businesses have no political representation or influence in states in which they have no physical presence and will be subjected to unfair tax burdens if they are subject to taxation in such states.

Rebuttal:

- This argument has been forcefully rebutted by leading state tax experts Walter Hellerstein of the University of Georgia Law School and Charles McLure of Stanford University's Hoover Institution.[12] They note that corporations don't have the right to vote. In addition, states have an unquestioned right to tax the income earned within their borders and property owned there by non-resident *individuals* who also don't have the right to vote in states in which they are subject to taxation. In short, "no taxation without representation" as an argument for BATSA is a red herring.

- Hellerstein and McLure also observe that because the courts have made clear that states may not discriminate in their tax policies against out-of-state businesses, lobbying by in-state businesses (which clearly do have significant political influence in a state) against onerous tax policies also protects the interests of out-of-state businesses.

Claim:

There is a disturbing trend of states raising revenues through aggressive assertion of nexus over out-of-state companies with little or no presence within their borders, which the states then use to finance economic development tax breaks to corporations that do have substantial property or employees within the state. BATSA is needed to put a stop to such discrimination in favor of in-state firms at the expense of out-of-state firms.

Rebuttal:

This is an ironic argument for BATSA proponents to make:

- A number of corporations supporting BATSA have worked actively for an increasingly common change in state tax policy that, in the name of economic development, is explicitly aimed at shifting the corporate income tax burden off of corporations with a substantial physical presence in a state and onto out-of-state corporations with little physical presence in a state. (See: http://www.cbpp.org/files/1-26-05sfp.pdf.) For example, Bayer Corporation, Dick's Sporting Goods, General Electric, The Walt Disney Company, and Johnson & Johnson are members of coalitions that have actively lobbied for this policy (a "single sales factor apportionment formula") in Pennsylvania and California.[13]

- Many business organizations supporting BATSA also sought the enactment of the "Economic Development Act of 2005" (S. 1066/H.R. 2471). The goal of this bill was to preserve existing state economic development tax incentives. The EDA was aimed at stopping challenges to tax incentives based on the argument that they discriminate against out-of-state businesses in violation of the Constitution's Commerce Clause. In other words, the many BATSA proponents that also supported the EDA tried to *preserve* the right of states to discriminate in favor of in-state businesses by providing them with tax breaks.

- BATSA itself has one provision that intentionally discriminates against certain out-of-state businesses in the name of state economic development. In order to help states drum-up business for in-state corporations from out-of-state corporations, BATSA declares that physical presence in a state in connection with being a *purchaser from* an in-state business is not nexus-creating. This provision discriminates against out-of-state businesses that may have an equivalent number of employees or an equivalent amount of property in a state but will not be from state taxation by BATSA because that physical presence is involved in *selling to* an in-state business.

Claim:

The aggressive efforts of state tax administrators to assert nexus over corporations that merely have customers within their borders are creating enormous uncertainty for these businesses about their BAT payment obligations. This uncertainty is "chilling. . . interstate economic activity," encouraging U.S. corporations to invest abroad rather than here, and discouraging foreign corporations from investing in the United States.

Rebuttal:

- BATSA proponents substantially exaggerate both the nexus enforcement efforts of state tax officials and the uncertainty surrounding the state of BAT nexus law. There is no uncertainty about the nexus rules that apply to businesses that conduct the vast majority of transactions in the U.S. economy. P.L. 86-272 governs the application of state corporate income taxes to sellers of physical goods, and state tax officials can't get around it no matter how "aggressive" they might like to be in theory. Where P.L. 86-272 doesn't apply, there is little ambiguity in practice, because the majority of transactions are made with some in-state physical presence of the selling corporation (which clearly creates nexus). The majority of court cases and enforcement actions that have been initiated by states to compel income tax payments by allegedly non-physically-present corporations have been aimed at nullifying a single, abusive tax shelter that, in fact, relies on the physical presence within the state of the out-of-state corporation's trademark.[14]

- In the 14 years that BATSA has been under consideration in Congress, and with all the millions of businesses operating in the United States, BATSA proponents have managed to come up with only a single example of a company that allegedly decided not to make cross-border sales into a (single) state because of the state's assertion of nexus over it despite its lack of physical presence within the state.[15] The isolated small service business aside, it is highly implausible that large, national businesses are constraining their own growth by deciding not to do business in particular states because of BAT nexus issues. Where are the examples of national fast-food chains that refuse to license franchisees in particular states because of fears of assertion of nexus over the franchisor? Where are the examples of national banks that won't issue credit cards to residents of particular states because of nexus concerns? Until such examples are provided and documented, claims that interstate commerce — and therefore job growth— is being significantly stifled by concerns about creating BAT nexus in additional states should not be given any credence.

- If anything, the enactment of BATSA is likely to harm the economy by providing a *disincentive* for optimal business location decisions. As the former Director of the Oregon Department of Revenue has argued:

> [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[16]

BATSA proponents argue that the bill is needed to prevent "aggressive" state assertion of nexus from stifling interstate commerce, which they suggest is synonymous with interstate *sales*. They completely fail to acknowledge that interstate commerce also encompasses interstate *investment and job creation*, and that BATSA has the potential to discourage this by creating an artificial, tax-based incentive for corporations to tap into the consumer market in a state without placing facilities and jobs within the state's borders.

- This same logic undermines the (unsubstantiated) claims that nexus uncertainty is encouraging U.S. businesses to produce abroad and discouraging foreign direct investment in the United States. If anything, it is much more likely that the enactment of BATSA would have these effects. BATSA would allow both foreign subsidiaries of U.S.-based corporations and foreign-based corporations to conduct more activities in the United States to "establish and maintain" their markets here without creating BAT nexus. This could encourage them to fulfill U.S. demand for their goods and services through export from foreign factories and other facilities rather than produce those goods and services here with American workers. Moreover, the data on foreign direct investment do not substantiate the claim that BAT nexus "uncertainty" is putting a "real damper" on foreign direct investment here. While such investment fluctuates enormously over the business cycle and remains below the peak year of 2000, it rose steadily from 2002 through 2008. Since then it has remained well above the level of the early 1990s, when a few states began to enforce the allegedly aggressive, "economic presence" approach to defining nexus.[17]

Claim:

If the state nexus threshold for the imposition of a BAT is not raised at least as high as the provisions of BATSA, the U.S. economy and U.S. corporations are at substantial risk of retaliation from foreign governments that are angry that corporations headquartered in their nations can have income tax nexus in a state without having a "permanent establishment" in the United States. Foreign governments might also seek to renegotiate their tax treaties with the United States to eliminate the PE threshold. This would free them to impose their national-level corporate income taxes on non-physically-present U.S. corporations, just as states are imposing their income taxes on non-physically-present foreign corporations. Thus, "[e]nactment of BATSA, which includes a nexus standard that is analogous to those found in U.S. tax treaties, is essential for ensuring that the current international system of taxation remains intact."[18]

Rebuttal:

- BATSA proponents have presented no evidence to back up their claim that the United States is at risk of economic harm due to retaliation from foreign governments angered by state nexus standards that differ from "permanent establishment" rules. To the contrary, a report issued periodically by the European Union details U.S. federal and state policies that the EU views as trade barriers but makes no mention of state nexus standards — even as it does object to other state tax practices.[19]

- State nexus thresholds have been far lower than the PE standard for decades. There is no evidence that foreign governments have ever actively sought to renegotiate the tax treaties to eliminate the PE rules so that they could apply their national-level taxes to non-physically-present corporations in retaliation for state nexus thresholds that are lower than the PE rules. In any case, the federal government would be under no compulsion to accept a demand from foreign treaty partners that the PE standard be eliminated.

Notes

[1] Two leading experts on state taxation concur:

> 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 the 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 of whether the state has given anything for which it can ask in return.

Charles E. McLure Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004, p. 721. The article was sponsored by the National Governors' Association. McLure is a Senior Fellow with the Hoover Institution at Stanford University and was Deputy Assistant Secretary of the Treasury for Tax Analysis during the Reagan Administration. Walter Hellerstein is Francis Shackelford Professor of Taxation at the University of Georgia Law School and author of the most well-known legal treatise on state taxation.

[2] It is true that the *Whitney* and *International Harvester* cases focused on whether New York and Wisconsin, respectively, had the right to tax the income of the out-of-state recipients rather than assert taxing jurisdiction over the recipients themselves. It is also true that both cases were decided before *Quill* articulated a novel legal principle that the Due Process and Commerce Clauses of the Constitution imposed their own — and different — nexus requirements for state taxation of out-of-state corporations. Nonetheless, given the Court's explicit statements in *Quill* that its earlier cases had not established a physical presence nexus threshold for taxes other than the sales tax, it arguably is more likely than not that states have the authority under current constitutional law, at least in certain circumstances, to impose business activity taxes on income earned by non-physically-present companies.

That conclusion was supported by the late Jerome Hellerstein, widely recognized as one of the preeminent experts of the last 50 years on constitutional law bearing on state taxing authority. In an article written *after* the *Quill* decision, he stated: "The U.S. Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is *not* essential to the state's income tax on income of a nonresident."

In short, the Supreme Court determined long ago that, at least in certain circumstances, it is entirely fair for a state to tax the income earned within its borders by a non-physically-present person or business.

[3] Courts in Illinois, Indiana, Iowa, Louisiana, Maryland, Massachusetts, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina, and West Virginia have held that physical presence is not required for BAT nexus. Courts in Tennessee and Texas have held that it is. A Missouri case cited by BATSA proponents as supporting their position was decided on state law grounds having nothing to do with nexus under the Constitution. An Alabama case they also cite was effectively reversed by a subsequent decision. Recent decisions in Indiana, New Jersey, Oklahoma, and West Virginia held that physical presence was required for nexus under the specific facts of the cases but did not overrule previous cases in each state finding that physical presence is not inherently required.

[4] State court decisions in Iowa, Massachusetts, New Jersey, North Carolina, and West Virginia that upheld the states' positions that a business need not be physically present in a state to have BAT nexus there were all appealed to the U.S. Supreme Court. The Supreme Court denied review in all five cases.

[5] See a letter dated November 11, 1995 from Fred E. Ferguson of Arthur Andersen representing the Financial Institutions State Tax Coalition to the Chairman of the Multistate Tax Commission in support of the proposed financial institutions apportionment regulation. The letter states: "The FIST Coalition believes that the Apportionment Rules should serve as the model for uniform state apportionment of income of financial institutions. We encourage the MTC to adopt the rules, recommend that its member states favorably consider the rules for adoption, and urge the MTC to seek uniform adoption among non-member states as well." The rules FIST endorsed included provisions assigning receipts from interest to the states in which a bank's borrowers are located. Members of the FIST Coalition named in

the letter included Citicorp, which now support BATSA. See also a letter dated April 16, 1990 from Ruurd Leegstra of Price Waterhouse to the MTC's General Counsel accompanying a "Proposal of the Broadcasters" dated April 13, 1990 and drafted by the ABC and NBC networks. The proposal included a provision apportioning advertising receipts of radio and television broadcasters based on the location of listeners/viewers. Both letters are on file in the headquarters office of the MTC.

[6] See: OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?* Final Report, 2006. For example, see paragraphs 43, 44, 51, and 120.

[7] See the source cited in the previous note. "For the [task force], fundamental changes should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that have been suggested so far appears to meet that condition. The need to refrain from fundamental changes unless clearly superior alternatives are found is especially important since any attempt to change the fundamental aspects of the current international rules for taxing business profits would create difficult transition rules given the fact that many countries would likely disagree with such changes and that a long period of time would be required for the gradual adaptation of the existing network of tax treaties."

[8] *Tyler Pipe* v. *Washington*, 1987. In *Tyler Pipe*, the Court held that hiring an independent representative in a state to solicit sales and conduct other activities that helped an out-of-state corporation create and maintain a market for its products was no different from having an employee in a state engaged in the same activities and did indeed establish BAT nexus for the out-of-state corporation. There was no suggestion whatsoever in the case that the holding would have been any different if the in-state representative had solicited sales on behalf of more than one out-of-state company; indeed, the evidence strongly suggests that it did. The *Tyler Pipe* decision of the Washington State Supreme Court, which the U.S. Supreme Court reviewed, states that the Washington representative of Tyler Pipe was Ashe and Jones, Inc. of Seattle. Ashe and Jones was characterized by Tyler Pipe as an independent contractor, suggesting that it solicited Washington sales on behalf of multiple out-of-state businesses. Ashe and Jones appears to have been at that time a typical "manufacturers' representative" firm with multiple clients. The company certainly has multiple clients today, including Tyler Pipe. See: http://www.sdajnw.com/products/commercial.html .

[9] Bradley W. Joondeph, "Are State Courts Biased Against Taxpayers that Seek the Protection of Federal Law?" *State Tax Notes*, October 27, 2003. Cases interpreting the application of P.L. 86-272 since 2003 include *Alcoa Building Products* v. *Mass. Commissioner of Revenue* (2003), *Asher* v. *N.J. Division of Taxation* (2005), and *Inova Diagnostics, Inc.* v. *Texas Comptroller of Public Accounts* (2005).

[10] See, for example, footnotes 16 and 17 of the letter to the House Judiciary Committee Subcommittee on Commercial and Administrative Law in support of BATSA from the Coalition on Rational and Fair Taxation dated April 13, 2011. Those footnotes identify 13 cases litigated since the *Quill* decision. There have been about 10 additional cases not listed there in Louisiana, Oklahoma, Iowa, and Washington.

[11] See: *Wisconsin Dept. of Revenue.* v. *William Wrigley, Jr., Co.*, 1992. In 1972 the Supreme Court had heard a case on a very narrow issue involving the interaction between Public Law 86-272 and state regulation of the sale of alcohol.

[12] See the source cited in Note 1, p. 735.

[13] Bayer Corporation, General Electric, Johnson & Johnson, and Dick's Sporting Goods were members of the "CompetePA" coalition lobbying for the so-called "single sales factor apportionment" incentive in Pennsylvania. See: http://206.193.231.121/CompetePA/Members.asp .

Johnson & Johnson and Walt Disney were members of the "Coalition for a Competitive California" lobbying for single sales factor legislation there. See "Report of Lobbying Coalition" for the first quarter of 2008, available at cal-access.ss.ca.gov/Misc/pdf.aspx?filingid=1326354&amendid=0. The latter two companies also funded the "No on 24" campaign in the fall of 2010 opposing a ballot measure that would have repealed California's single sales factor law. All five of these companies are listed as current members of the Coalition for Interstate Tax Fairness and Job Growth at www.interstatetaxfairness.com/who-we-are/.

[14] For a description of how this "intangible holding company" tax shelter operates, see p. 5 of the Center's analysis of BATSA.

[15] See the testimony of Carey J. Horne on pp. 9-13 of the September 27, 2005 hearing on H.R. 1956 before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee. H.R. 1956 was the version of BATSA introduced in the 109th Congress.

[16] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001.

[17] Data on annual foreign direct investment flows into the United States are available at https://www.bea.gov/international/di1fdibal.htm. The first high-profile attempt by a state to enforce an "economic presence" nexus standard against a Delaware trademark holding company was the *South Carolina* v. *Geoffrey* case decided by the South Carolina Supreme Court in 1993.

[18] See the source cited in Note 10.

[19] See: European Commission, "United States Barriers to Trade and Investment, Report for 2008," July 2009, p. 68.

The Financial Services Roundtable

Statement for the Hearing Record

House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Hearing on H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

Hearing Date: 26 February, 2014

The Financial Services Roundtable (FSR) thanks Chairman Bachus and Ranking Member Farenthold for holding this important hearing on *H.R. 2992, the "Business Activity Tax Simplification Act of 2013 (BATSA),"* and for the opportunity to submit a comment for the hearing record. FSR supports H.R. 2992 and encourages the Committee to report this legislation out of the Committee.

The Financial Services Roundtable is the leading advocacy organization for America's financial services industry. FSR members include the leading banking, insurance, asset management, finance and credit card companies in America. We are financing the American economy — creating jobs, expanding businesses, securing homes, businesses and retirement, insuring growth and building consumer confidence.

To date, financial institutions face a complex web of states' business activity tax standards that hinder economic investment and growth while increasing compliance costs. *H.R. 2992, the "Business Activity Tax Simplification Act of 2013,"* would bring greater uniformity to business taxation related to interstate commerce. This would give financial institutions greater certainty and a more stable economic environment in which to invest and create jobs, as well as minimize legal and compliance costs that hamper economic growth and increase costs on consumers.

Background

The states' taxation of business activity has evolved since the nation's founding, but underwent a significant change in 1977 when the U.S. Supreme Court, in the *Complete Auto* decision, determined that states may tax interstate commerce if it meets a four-part test. The four parts include non-discriminatory, fairly apportioned, related to services, and applies only to businesses with substantial presence. Each component of this four-part test is critical, but for purposes of this testimony, FSR will focus on the "substantial presence" or "*nexus*," which relates to the connection between the state and the taxpayer.

Currently, many states have or are considering different standards for what constitutes this *nexus*. Lowering the threshold for what constitutes a nexus makes it easier for states to establish the relationship and assess the tax. Not only does the threshold for what constitutes a nexus vary by state, but even the duration of the *nexus* after a business no longer has a physical presence in the state varies. Both of these factors drastically impact state taxation treatment of business activity.

BATSA would correct this disparate treatment by expanding the prohibition against state taxation of an out-of-state entity unless that entity has a physical presence in the taxing state. This creates a uniform threshold for the *nexus*, or relationship, between the state and the taxpayer: physical presence. This clarity will increase economic certainty and decrease legal costs on businesses, both of which spur job creation and lower consumer costs.

BATSA, Economic Growth, and Job Creation

FSR's membership operates across the country. In addition, the advent of online products and services has broken down state borders. Our institutions serve consumers across the nation, whether the institution has a physical presence in a particular state or not.

Unfortunately, different states have different threshold levels for the nexus that would allow a state to tax interstate commerce. By the very nature of this patchwork system, financial institutions large and small are forced to comply with disparate standards that increase compliance and legal costs. In the most extreme cases, institutions will choose not to operate in certain state jurisdictions, ultimately reducing the competition that leads to greater consumer choice and value. In most cases, however, the institution will continue to operate in the jurisdictions, but be burdened with excess compliance costs that result increase consumer costs.

In addition, these complex and costly compliance requirements impair a financial institution's ability to allocate capital to consumer products and services, innovation, and investment thatcreates jobs. . Every dollar spent complying with disparate and complex state tax codes is a dollar that will not be spent on new employees, new equipment, and customer service. Compliance costs are part of doing business, but additional burdens should not hamper business simply because different states apply different business activity tax standards.

Finally, it is important to note that this patchwork system impacts financial institutions and businesses simply by creating uncertainty. As states consider and adopt different standards, uncertainty muddles the ability for businesses to make informed decisions. This can hinder investment that drives economic growth and job creation just as much as the direct compliance costs referenced earlier. Congress has the power, with H.R.

2992, to address these issues and help provide economic certainty and reduce costs facing financial institutions. FSR encourages this Committee to support the legislation.

Conclusion

FSR thanks the Subcommittee for the opportunity to submit comments for the record. We support H.R. 2992, the "Business Activity Tax Simplification Act of 2013 (BATSA)," because it will enhance uniformity in the taxation of business activities, lowering compliance costs and fostering a stable economic environment for investment and job creation. We urge the full Committee to markup and report the bill out of Committee.

Thank you.

Statement
Of
The Ad Hoc Fair Hotel Tax Collection Coalition
For the Hearing on the Business Activity Simplification Tax Act
In
The Subcommittee on Regulatory Reform, Commercial and Anti Trust Law
Committee on the Judiciary
February 26, 2014

The Ad Hoc Fair Hotel Tax Collection Coalition is composed of organizations dedicated to preserving the rights of state and local governments to impose and collect hotel taxes. The Coalition opposes HR 2992, the Business Activity Simplification Tax Act of 2013 (BATSA) because it would create opportunities for Online Travel Companies (OTCs) to avoid collecting and remitting at least a portion of hotel taxes. In some jurisdictions hotel taxes are imposed directly on a party renting a hotel room to the hotel occupant, i.e. the tax would be a business activity tax of renting the hotel room to the room occupant. BATSA would allow OTCs to structure their business operations through independent contractors even if the independent contractor is controlled by the OTC. When operating in this type of business structure the OTC would not be deemed to not have a physical presence in a jurisdiction and not be required to pay hotel taxes imposed as a result of the business activity of renting hotel rooms.

OTCs rent hotel rooms directly to a hotel room occupant. The OTC has the right to rent hotel rooms, gives the occupant the room rental rate, and collects the room rent from the occupant. Hotel taxes may be paid by the OTC to the hotel for the right to rent the room. The tax on this right is based on the wholesale price of the room charged to the OTC. However, there is a markup of the wholesale price charged to the hotel room occupant that typically ranges from 25 to 40 percent of the wholesale price. The hotel tax due on the mark up would not have to be paid if the OTC avails itself of the business structure allowed by BATSA even though the OTC is renting a room in the jurisdiction imposing the hotel tax.

Litigation over the correct amount of hotel taxes due on room rentals by OTCs has been pursued by states and local governments for more than a decade. In those jurisdictions that impose the tax directly on the OTC a lesser amount would be collected than when the tax is imposed on the hotel room occupant because of BATSA. When the hotel tax is imposed directly on the hotel room occupant the OTC has been required in many jurisdictions to collect and remit the hotel tax on the markup price (retail rice) of the room rental. We believe that federal legislation should not create a discrepancy on the amount of the hotel tax collected based on the difference of imposing the tax on the OTC or the hotel room occupant.

We appreciate the opportunity to submit this statement. For additional information please contact: Marty Morris at 202.302.7296.

Statement

of Mark Louchheim
President
Bobrick Washroom Equipment, Inc.
North Hollywood, CA
On *behalf* of the National Association of Manufacturers

For the Hearing Record

House Judiciary Subcommittee on Regulatory Reform,
Commercial and Antitrust Law

on H.R. 2992: The Business Activity Tax Simplification
Act of 2013

February 26, 2014

Statement of the National Association of Manufactures

For the Hearing Record

House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law
U.S. House of Representatives

Hearing on
H.R. 2992: The Business Activity Tax Simplification Act of 2013

February 26, 2014

Mr. Chairman and Members of the Subcommittee,

I am pleased to have the opportunity to submit this statement on behalf of the National Association of Manufacturers (NAM) for the record of the February 26, 2014, House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law hearing on H.R. 2992, The Business Activity Tax Simplification Act.

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 21 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. 2992, the Business Activity Tax Simplification Act (BATSA), introduced in 2013 by Rep. Jim Sensenbrenner (R-WI) and cosponsored by several House Judiciary Committee members. 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.

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 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 cannot 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. 2992, 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.

Statement by:

Mark Louchheim
President
Bobrick Washroom Equipment, Inc.
11611 Hart Street
North Hollywood, CA 91605-5882
Phone: (818) 764-1000

On Behalf of:

National Association of Manufacturers
733 10th Street, NW
Suite 700
Washington, D.C. 20001
Phone: (202) 637-3000

NAM contact: Christina Crooks, (202) 637-3076, ccrooks@nam.org

Software Finance & Tax Executives Council

www.softwarefinance.org

BEFORE THE COMMITTEE ON THE JUDICIARY,

SUBCOMMITTEE ONREGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW,

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING H.R 2992:

"THE BUSIENSS ACTIVITY TAX SIMPLIFICATION ACT OF 2013"

FEBRUARY 26, 2014

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. 2992, "The Business Activity Tax Simplification Act of 2013." 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. 2992 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*, 987 N.E.2d 621 (2013).

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 the National Governors Association that codification of the physical presence in the area of business activity taxes would represent an unwarranted federal intrusion into state affairs, allow companies to avoid and evade state business activity taxes, increase the tax burden on small business and individuals, alter established constitutional standards for state taxation and cost state billions in existing revenue. To these charges, we merely point out that the power of Congress to regulate in this area clearly is conferred by the Commerce Clause and is not unwarranted, given the states' behavior in this area, as documented by the Tax Foundation's testimony,.

In particular, we call out the Governors' claim that businesses will take advantage of a stronger physical presence standard by forming "entities in jurisdictions that do not tax certain activity, followed by a shift of income or property to the entity to avoid taxation." First, in order for a company to take advantage of a state's law exempting certain categories of income, the business would have to move the income to the state and the only way to do that effectively is to move property and employees to the state.

Second, we note the likely purpose of such a state's law would be to lure businesses to the state, in competition with other states that tax such income. We see nothing wrong with a taxpayer moving property and employees to a state to take advantage of a tax incentive; they do it all the time, with the encouragement of state legislatures and governors. Engaging behavior encouraged by the state's law is neither abusive nor improper. We suspect the governors of those states with such incentives would be surprised to learn their trade association was providing testimony to the Congress disparaging them.

Business have always been able to control where their income is taxable merely by making astute decisions about where they locate their property and employees, decisions that do no rise to the level of evasion or avoidance and are legitimate in all respects. Any increases in the tax burden on local businesses and decreases in existing revenue are the result of state budgets financed with revenue collected unconstitutionally from out of state business with no nexus with states where they have no property or employees.

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.
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> *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 its enactment. Because it is limited to sales of tangible personal property, P.L. 86-272 may not apply to licenses of software or 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 its 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 2013, H.R. 2992 ("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.

Unions Oppose "Business Activity Tax Simplification Act of 2013", H.R. 2992

February 26, 2014

Dear Representative:

The undersigned labor unions urge you to oppose the "Business Activity Tax Simplification Act of 2013" (BATSA), H.R. 2992. Our unions oppose this troubling proposal because it would impose an unfunded mandate and permanently shrink state and local government tax revenues. H.R. 2992 would limit states and localities from determining and keeping their own tax systems, and it encourages and rewards businesses and large profitable corporations for taking business decisions designed to aggressively avoid taxes.

The Congressional Budget Office's (CBO) September 2011 review of an identical BATSA bill estimated it would reduce state and local government revenues by "about $2 billion in the first full year after enactment and at least that amount in subsequent years." CBO's review also stated, "Subsequently, corporations likely would rearrange their business activities to take advantage of beneficial tax treatments that would result from the interaction of the new federal law and certain state taxing regimes. Those changes in business activities would likely result in additional revenue losses to the states" in excess of the $2 billion direct loss. H.R. 2992 is worse than its predecessors in some prior Congresses. For example, H.R. 2992 now has an added provision limiting state authority to impose combined reporting, which previously would have partially counteracted effects of earlier versions of this bill.

H.R. 2992 is designed to reduce business taxes now being paid to states and localities. Under current law, these governments have the authority to and do tax businesses that have employees and/or property within their borders temporarily. H.R. 2992 would effectively prevent states and localities from taxing any business that did not have a permanent "brick-and-mortar" presence within the jurisdiction. Moreover, even permanently-present businesses could shelter substantial amounts of profits from state and local taxation due to loopholes that H.R. 2992 would open. H.R. 2992 also would vastly and unjustifiably expand the scope of an existing limit on state corporate income taxes, Public Law 86-272. While Public Law 86-272 currently restricts jurisdictions in imposing taxes on sellers of goods, H.R. 2992 would extend Public Law 86-272 to sellers of services (e.g. banking or media) and intangibles (e.g. franchisors). Furthermore, H.R. 2992 would extend P.L. 86-272 to many taxes to which it does not currently apply, such as the Washington Business and Occupation Tax, Texas Franchise Tax, Ohio Commercial Activities Tax, and New Hampshire Business Enterprise Tax.

CBO has determined that BATSA is an unfunded mandate - "by prohibiting state and local governments from taxing certain business activities," BATSA "would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA)." This unfunded mandate and $2 billion annual loss would worsen already severe state and local budget problems and potentially force cuts to education, health care, job creation and other vital public services.

Some corporations design their operations to avoid nexus in states where they earn profits and produce a self-serving paper trail of "nowhere" income – to try to prevent states from taxing their income. H.R. 2992 would protect these tax shelters, increase their quantity and dollar value, and reward these tax avoidance actions. Large profitable corporations will take advantage of these combined practices to shift the tax burden further onto state and local residents.

We urge every Congressmember to oppose preempting state and local government taxing authority and preventing states and localities from creating viable and equitable tax systems.

Sincerely,

American Federation of Labor and Congress of Industrial Organizations (AFL-CIO)

American Federation of State, County and Municipal Employees (AFSCME)

American Federation of Teachers (AFT)

Communications Workers of America (CWA)

Department for Professional Employees, AFL-CIO (DPE)

International Association of Fire Fighters (IAFF)

International Federation of Professional and Technical Engineers (IFPTE)

National Education Association (NEA)

Service Employees International Union (SEIU)

International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW)