BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2003

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

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ON

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THURSDAY, MAY 13, 2004

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

The Subcommittee met, pursuant to call, at 2:05 p.m., in Room 2141, Rayburn House Office Building, Hon. Chris Cannon (Chair of the Subcommittee) Presiding.

Mr. CANNON. Good afternoon, ladies and gentlemen. This hearing of the Subcommittee on Commercial and Administrative Law will now come to order. We are here today to consider H.R. 3220, the "Business Activity Tax Simplification Act of 2003."

This is a measure intended to provide greater clarity for businesses in navigating the tax landscape. This bill was introduced by the gentleman from Virginia, Mr. Goodlatte, on October 1 of last year. It has 30 cosponsors, of which I am one. We expect Mr. Goodlatte to join us soon.

H.R. 3220 is designed to address a fundamental problem related to interstate commerce. When is a State justified in taxing businesses with little or no physical connection with that State? While Congress has examined this issue for years, the emergence of the Internet economy has made the need for clear and concise taxation standards even more urgent.

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

Since 1959 the economy has reshaped itself dramatically. Companies offer not only tangible goods but intangible property and services to customers across the country. The emergence of the Internet has served as the major catalyst of this transformation. But because Public Law 86–272 does not address intangible goods, it falls short in addressing the current tax landscape.

In addition, since 1959 many States appear to have engaged in practices that are at odds with the meaning and intent of Public Law 86–272. For example, States have begun to impose a tax on a company's business activities on gross receipts rather than on net income. These developments have wreaked havoc on businesses who have incurred great expense in attempting to decipher and in litigating the appropriate nexus standards for business activity taxes.

H.R. 3220 would provide some certainty to this dispute. It would amend Public Law 86–272 to apply to solicitation activities in connection with all sales, not just sales of tangible personal property. It would also cover all business activity taxes, not just net income taxes.

H.R. 3220 would codify the current physical presence standard observed for years and elaborated by the Supreme Court in 1992 in Quill vs. North Dakota. In that case the Court required physical presence by accompanying an order for a State to impose a requirement that remote vendors collect and remit sales taxes for sales made within the State.

Similarly, H.R. 3220 stands for the concept that the economic burden of actual tax imposition should be borne by those persons who received the benefits and protections of a State. It establishes a bright line 21-day physical presence requirement for the imposition of business activity taxes.

During the 107th Congress the House considered a similar measure, H.R. 2526, also sponsored by Mr. Goodlatte. While that bill was reported favorably by this Subcommittee, the full Committee on the Judiciary did not have the opportunity to consider it prior to the conclusion of the Congress.

Numerous business associations have expressed their strong support for H.R. 3220, including the National Association of Manufacturers, the Direct Marketing Association, the American Trucking Association, and the Information Technology Association of America, to name only a few.

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

I look forward to the testimony of our highly informed panel.

I ask unanimous consent that Members have 5 legislative days until the close of business Thursday, May 20, to submit written statements for inclusion in today's record.

I yield to Mr. Watt, the Ranking Member of the Subcommittee, for an opening statement.

Mr. WATT. Thank you, Mr. Chairman. I thank the Chairman for convening the hearing and I especially thank him for convening the hearing on this matter because it seems to me that this is exactly the kind of issue that we need to have a full hearing or set of hearings on so that we can understand the consequences of what we are doing and where exactly the line should be drawn.

I am not a cosponsor of the bill but I do not think anybody should read anything into that either positively or negatively about the bill. It simply means that there are strong advocates who have expressed themselves on both sides of this proposed legislation, and perhaps the best example of that would be the fact that I have two pieces of correspondence which I would like to ask unanimous consent to submit for the record.

Mr. CANNON. Without objection, so ordered.

Mr. WATT. One from the National League of Cities in opposition to the bill and one from Congressman Greg Meeks of New York's Sixth Congressional District in support of the legislation.

[The information referred to follows in the Appendix]

Mr. WATT. So I am not brokering for either side in this debate. I came to listen and to learn and I feel like we have a great panel to help us do that. So I am looking forward to hearing the testimony, and with that I will yield back and we can get on to it.

Mr. CANNON. I thank the gentleman. The Chair notes and welcomes the presence on the dais of the gentleman from Virginia, Mr. Goodlatte. Although not a Member of the Subcommittee, he is a Member of the full Judiciary Committee and a sponsor of the legislation which is the subject of today's hearing. Mr. Goodlatte, we welcome you and are grateful for your continuing efforts.

The Chair exercises the discretion of this instance and would recognize Mr. Goodlatte for 5 minutes for any remarks he wishes to make. In addition, let me point out that the rules of the Committee require that a person who is not a Member of Committee who is going to ask questions needs to have time yielded so even though you are the only person here we will make time to yield for Mr. Goodlatte to ask questions when we get to that point.

Mr. WATT. Can I just ask unanimous consent that we waive that rule for today's hearing because I think we would certainly benefit from Mr. Goodlatte being able to make an opening statement and ask questions.

Mr. CANNON. Without objection, so ordered. By the way, let me say that, Mr. Delahunt, you are a Member of the panel. Would you like to make an opening statement before Mr. Goodlatte?

Mr. DELAHUNT. I will defer to the gentleman.

Mr. CANNON. I thank you. Mr. Goodlatte, you are recognized for 5 minutes.

Mr. GOODLATTE. Mr. Chairman, thank you and I thank the Ranking Member for his courtesy and generosity for allowing me to participate but thank you even more for holding this important hearing.

With the growth of Internet companies increasingly able to conduct transactions without the constraints of geopolitical boundaries, over the past several years a growing number of jurisdictions have sought to collect business activity taxes from businesses located in other States, even though those businesses receive no appreciable benefits from the taxing jurisdiction and even though the Supreme Court has ruled that the Constitution prohibits a State from imposing taxes on businesses that lack substantial connections to the State. This has led to unfairness and uncertainty, generated contentious, widespread litigation, and hindered business expansion due to fear of exposure to unfair tax burdens.

In order for e-commerce and interstate commerce generally to continue to grow and prosper, it is imperative that clear and easy navigable rules be set forth regarding when an out-of-State business is obliged to pay business activity taxes to a State.

Last year I introduced along with Congressman Boucher H.R. 2320, the Business Activity Tax Simplification Act. This important legislation provides a bright line that clarifies State and local authority to collect business activity taxes from out-of-State entities, which will bring predictability to an unpredictable tax environment for businesses and States.

Specifically, the bill would establish a physical presence test such as an out-of-State business would be obliged to pay business activity taxes to a State only if the out-of-State business has a physical presence in the taxing State. This physical presence test is not new. It basically codifies the majority view among the States that the Constitution requires a physical presence as opposed to other unclear standards before a State can impose business activity taxes on an out-of-State business.

The Business Activity Tax Simplification Act would also amend an outdated Federal statute to bring it up to speed with the current economy. Public Law 86–272, enacted in 1959, provides a State may not tax an out-of-State business when the out-of-State business's only contact with the State is the solicitation of orders for tangible personal property within that State. The Business Activity Tax Simplification Act amends the public law to change its application from merely the solicitation of orders for tangible personal property to cover all products, tangible or intangible, as well as services. This change will bring the public law up to speed with the economy of the 21st century, which increasingly involves the delivery of intangible property and services.

The Business Activity Tax Simplification Act is good for businesses because it creates certainty. Instead of devoting time and resources to defending frivolous and often conflicting claims from multiple-State taxing authorities, this legislation will allow businesses to devote more resources to increasing efficiencies and reducing costs for consumers. Instead of the current tax environment, which requires small businesses to run blindfolded through a forest of tax regulations in the hopes that they will not somehow trigger hidden tax liability in that State, this legislation will create a bright line test so that businesses will know the general parameters of when they could be taxed by a State.

But businesses are not the only ones who would benefit from this bill. The Business Activity Tax Simplification Act is good for States, too, because it protects in-State businesses from excessive taxation from other States. In addition, the physical presence test would help ensure that States do not lose tax revenues to other aggressive taxing jurisdictions. States too will benefit from the certainty this legislation provides because they will incur fewer costs associated with litigating these matters.

Furthermore, this bill protects the States' sovereign power to choose the rates and kinds of taxes to impose on businesses that are actually physically present within the State. States remain free to scope their own tax laws. Some like, the California Franchise Tax Board, have argued that States will suffer catastrophic revenue losses under H.R. 3220. However, closer look at the FTB's assertion reveals it is full of smoke screens and mirrors. The FTB speculates about revenues at risk rather than concrete revenue losses. It provides no discussion of the data or methodologies that went into the study, as is customary, and the study relies on predicting the future behavior of businesses.

Most importantly, it ignores the common law and statutory tools that California and other States have at their disposal to attack fraudulent corporate tax evasion schemes.

The Business Activity Tax Simplification Act is good for businesses, good for States, and good for the economy. I look forward to hearing the testimony of our export witnesses.

Mr. Chairman, thank you for allowing me to participate today.

Mr. CANNON. I thank the gentleman. Mr. Delahunt, did you want to make a statement? The gentleman is recognized for 5 minutes.

Mr. DELAHUNT. I thank the Chair. I just wanted to respond for a moment to my friend from Virginia where he argues that it is good for the States. I think we are here to learn, as the Ranking Member indicated, because I have heard from a number of tax commissioners from various States that obviously hold a contrary position. And again I think it is important to understand that this particular piece of legislation will create some winners and losers. And I look forward to that particular testimony because again even absent consideration of the need for revenue from the States, when it comes to our private sector I suggest we have to be very careful in terms of supporting economic activity. And if it creates in any way, shape or form an imbalance in terms of the ability of business to produce that economic activity, we should tread carefully.

I think also my friend from Virginia referenced the constitutionality issue. And I could be wrong, but I presume there has been no case brought for litigation which has decided whether this particular form of taxation is constitutional or unconstitutional. In Quill vs. North Dakota the Court indicated or limited the test to the duty of mail order houses to collect use taxes from customers, and the Court acknowledged that as to other taxes such as income taxes, and I understand there were two cases pending, it had not applied the physical presence test.

Many of the arguments that I think we are going to hear I think have been raised during the course of hearings on the moratorium of taxation on the Internet, which I support the position of the Chair of the Subcommittee and support it with vigor. But again there are other issues that the Subcommittee is dealing with also and we have had hearings as far as the collection of the sales tax and in moving again in that particular direction with an effort to streamline and to stay focused.

So with those comments, Mr. Chairman, I will yield back.

Mr. CANNON. I thank the gentleman from Massachusetts. There are several items I would like to touch on before we introduce the witnesses.

First of all, the record of this hearing will remain open for 5 legislative days for interested parties to submit statements for inclusion in the hearing record. In addition, Members will have 5 legislative days to submit additional follow-up questions to our witnesses for inclusion in the record.

As Mr. Delahunt just pointed out, we want to thank Mr. Chabot, the gentleman from Ohio, for joining us today. We expect several of the Members to be here. I know that all of them have a number of questions.

As Mr. Delahunt just alluded, there are several issues that are going on here that are related. The Internet Tax Freedom Act, which has been passed in its pure and proper form by the House of Representatives, now passed in abominable form by the other body. We will have to clear that up and I think there will be some questions on that, its relationship to the SSTP and of course to the BAT. So I expect several questions on that issue.

Mr. DELAHUNT. Mr. Chairman, can I ask unanimous consent to submit a CRS report dated March 23, 2004, entitled "State Corporate Income Taxes, A Description and Analysis," authored by Steven Maguire.

Mr. CANNON. Without objection, so ordered.

[The information referred to follows in the Appendix]

Mr. CANNON. Our first witness is Arthur Rosen, partner in the New York City law firm of McDermott, Will & Emery, where he chairs the firm's nationwide State and local tax practice. A graduate of New York University and St. John's University Law School, Mr. Rosen is a leading expert in the area of State and local taxation. He is the past chairman of the State and Local Tax Committee of the ABA's Tax Section and is a member of the Executive Committee of the New York State Bar Association.

Mr. Rosen is a nationally respected figure in the field of Internet and e-commerce taxation. He has worked to shape policy through participation in various venues and has lectured extensively throughout the country on State and local tax issues.

Mr. Rosen appeared before the Subcommittee for the hearings on H.R. 2526 on September 11, 2001, which was adjourned prematurely for obvious reasons. Mr. Rosen has graciously accepted another invitation to provide testimony. We hope our efforts today will prove successful.

Mr. Rosen, welcome back and we look forward to your testimony.

Our next witness is Jamie Van Fossen, State Representative for the 81st House District of the State of Iowa, who is more often on this side of the dais than on that. We welcome you. Mr. Van Fossen is serving his fifth term as State Representative and his third term as chairman of the Iowa House Committee on Ways and Means. Mr. Fossen is recognized for his work to lower taxes for job creating businesses in Iowa. He introduced Resolution 164, adopted last month in the Iowa House, requesting Congress to enact legislation updating Public Law 86–272.

In recognition for his leadership the American Legislative Exchange Council honored Mr. Van Fossen in 2001 as Legislator of the Year. He is also a three-time recipient of the Guardian of Small Business Award by the National Federation of Independent Business.

Mr. Van Fossen earned his Bachelor's Degree from St. Ambrose University. When not serving in the legislature, he is an economic analyst for Mid-America Energy Company in Davenport.

Mr. Van Fossen, we congratulate you for your substantial efforts and look forward to your testimony from the State perspective.

Our next witness is Rick Clayburgh, Tax Commissioner of the State of North Dakota. Mr. Clayburgh was elected as State Tax Commissioner in 1996. Commissioner Clayburgh is a former four-term State legislator representing a part of the city of Grand Forks in the North Dakota House from 1988 to 1996. Mr. Clayburgh is the Secretary of the State Board of Equalization as well as the

Treasurer of the Multistate Tax Commission. He is also a member of the Federation of Tax Administrators Board of Trustees and is actively involve in several charitable organizations, including the United Way, the Special Olympics and the Elks club.

Commissioner Clayburgh earned his Bachelor's Degree from Concordia College in Minnesota and his MBA and law degree from the University of North Dakota. We welcome you and we appreciate your testimony.

Our final witness is Mr. Vernon T. Turner, Corporate Tax Director for Smithfield Foods, Inc., located in Smithfield, Virginia.

Mr. Turner is responsible for all worldwide tax matters, including Federal, international and State tax issues. He has formed due diligence and acquisition structuring for numerous transactions. Prior to joining Smithfield Foods, Mr. Turner worked with two major accounting firms where he served a diverse client base in several industries.

Mr. Turner earned a Bachelor's Degree in business administration from James Madison University in Harrisonburg, Virginia. He is a licensed certified public accountant in Virginia and New York and serves as the State Tax Chairman for the Virginia chapter of Tax Executives Institute.

Mr. Turner,thank you for your appearance here today. I extend to you my warm regards and appreciation for your willingness to participate in today's hearing.

In light of the fact that your written statements will be included in the hearing record, I request you limit your oral remarks to 5 minutes. Accordingly, please feel free to summarize or highlight the salient points of your testimony. You will note that we have a lighting system that starts with a green light. After 4 minutes it turns to a yellow light and then in 5 minutes it turns to a red light. It is my habit to tap the gavel at 5 minutes. We appreciate if you would finish up your thoughts within that time frame. You do not have to stop. We are not cutting people off. I find it works better if everybody knows we have 5 minutes. We will have several people here asking you questions, so you will have time to elaborate on your ideas.

After all the witnesses have presented their remarks the Committee Members in the order they arrived will be permitted to ask questions of the witnesses subject to the same 5-minute time limit. Mr. Rosen, would you proceed with your testimony now?

STATEMENT OF ARTHUR R. ROSEN, TAX PARTNER, McDERMOTT, WILL & EMERY

Mr. ROSEN. Thank you, Mr. Chairman, Congressman Watt, Members of Subcommittee. Thank you for this opportunity to comment on H.R. 3220, the Business Activity Tax Simplification Act, or BATSA. I am Arthur Rosen, a member of the international law firm of McDermott, Will & Emery. I am here today representing the Coalition For Rational and Fair Taxation, or CRAFT, a diverse coalition of some of America's major corporations involved in virtually every industry with locations throughout the United States.

The underlying principle in BATSA is that only those States and localities that provide benefits and protections to a business should get that business' taxes rather than remote jurisdictions that provide no services to the business. BATSA does so in a manner that ensures that the business community continues to pay its fair share of taxes and puts a stop to unfair and new taxing positions.

BATSA also modernizes an important Federal law enacted in 1959. In recent years certain State tax collectors have been advocating a position that a State has the right to impose tax on a business that merely has customers there on the basis of what they call "economic nexus", even if the business has no physical presence there whatsoever.

While the taxpayers' position that physical presence is required has repeatedly been upheld by courts, those courts and State tribunals have rendered nonuniform decisions. This has led to overall confusion regarding the current rules governing State taxation that has in turn resulted in a chilling effect on interstate commerce.

CRAFT strongly supports BATSA and respectfully urges your approval of this legislation. We believe it is essential for Congress to act to provide clear guidance to the States in the area of interstate commerce. The current situation of uncertainty, overly aggressive State revenue departments, and the huge amounts of contentious controversy and litigation as well as the specter of enormous tax compliance responsibilities related to every State and thousands upon thousands of localities has placed a real drag on American business, hurting American job growth and harming the entire U.S. Economy.

In my practice I regularly see situations where business will decide not to undertake a new venture for fear of inappropriate State tax ramifications. As explained by the Chairman, enactment of BATSA will address these problems and ensure that the relevant law, Public Law 86–272, reflect the 21st century American economy.

Perhaps most important, BATSA guarantees fairness in interstate taxation. BATSA is simple, straightforward and quite limited and generally preserves the current state of the law. BATSA provides a 21-day test, where businesses that have people, employees, agents, or property in the State for more than 21 days during the year are subject to tax.

There are qualitative de minimis exceptions to that. That is when the business is merely a customer in the State, when it is patronizing local markets, when it is generating other tax revenues for the State.

BATSA also modernizes Public Law 86–272 to make sure it applies to all taxes, not just income taxes, and that it applies to sellers of goods other than tangible personal property.

There simply is no basis for any contention that BATSA could lead to any significant loss of State revenues. BATSA does not depart in any significant degree from what is now being done in the States, as has recently been confirmed by the former Executive Director of the Multistate Tax Commission.

Clearly State and local governments drive virtually all their business activity tax revenue from businesses that maintain employees, facilities, inventory or property in their jurisdiction for more than 21 days in the year. In reality, there simply could not be any material effect on the amount of revenue received by States.

Assertions that BATSA will decrease State revenues due to tax planning or, to use the recently overused and politically charged term "tax sheltering," are totally baseless. There is absolutely nothing in BATSA that prevents States from using many of the weapons in their arsenal to combat improper structures and transactions. There are in fact only five or six States that do not have specific laws, some long-standing, some recently enacted, that are fully effective in addressing these situations.

The recent MTC press release, for example, relied on a report prepared by the California Franchise Tax Board. I have on the table, and people can take if they wish, a thorough rational explanation why the assertions and conclusions in the FTB report are simply false.

The United States and its treaty partners have for decades adopted and implemented a permanent establishment rule which provides that a country will not impose an income tax on a business from another country unless the business maintains a substantial presence in the taxing country. Quite alarmingly, it has been said that some smaller countries, citing the efforts of the U.S. State revenue departments advocating economic nexus, are now saying they want to renegotiate their treaties with the United States so that they can begin taxing every U.S. Business that has customers in their country. This would be a disaster for the U.S. economy. Enactment of BATSA is thus essential for ensuring that the current international system of taxation remains intact.

My comments have only scratched the surface of why enactment of BATSA is important to the American economy and to ensure basic fairness without any material costs to the States. Thank you for your time. I welcome any questions.

[The prepared statement of Mr. Rosen follows:]

PREPARED STATEMENT OF ARTHUR R. ROSEN

STATEMENT OF
ARTHUR R. ROSEN

BEFORE THE

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

ON

H.R. 3220
THE BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2003

May 13, 2004

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

Thank you for this opportunity to address the Subcommittee concerning H.R. 3220, the Business Activity Tax Simplification Act. I want to especially thank you, Mr. Chairman, for holding this hearing on this important legislation affecting the American economy and to thank Congressmen Goodlatte and Boucher for their steadfast leadership in championing business activity tax simplification for several years now. I am Arthur Rosen, a member of the international law firm of McDermott, Will & Emery. Many of my partners at McDermott and I have been deeply involved in many of the relevant state tax issues for decades, having successfully represented the taxpayers in such landmark Supreme Court cases as *Quill*, *ASARCO*, and *Woolworth*. I am here today representing the Coalition for Rational and Fair Taxation ("CRAFT"), which is a diverse coalition of some of America's major corporations involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and multistate entertainment and service businesses. The businesses maintain locations throughout the United States.

My comments today will focus on why a bright-line, quantifiable physical presence nexus standard, as is provided in H.R. 3220, is the appropriate standard for state and local taxation of out-of-state businesses and why modernization of Public Law 86-272, as H.R. 3220 would accomplish, is essential to the U.S. economy. CRAFT strongly supports H.R. 3220 and respectfully urges your approval of this legislation for consideration by the full Congress and ultimate enactment. We believe that it is essential for Congress to act to provide clear guidance to the states in the area of state taxing jurisdiction, remove the drag that the current climate of uncertainty places on American businesses, and thereby protect American jobs and enhance the U.S. economy.

Overview

The principal motivation for the adoption of the United States Constitution as a replacement to the Articles of Confederation was a desire to establish and ensure the maintenance of a single, integrated, robust American economy. This is reflected in the Commerce Clause, which provides Congress with the authority to safeguard the free flow of interstate commerce. Perhaps the hallmark of American federalism is this assignment of authority to the federal government (along with responsibility for foreign affairs and the national monetary/fiscal system). Legislation regarding states and localities imposing, regulating, or removing tax burdens placed on transactions in interstate commerce is not only within Congress' realm of authority, it is also – I respectfully submit – Congress' responsibility. In addition to the Commerce Clause, this issue is also informed by the Due Process Clause of the Fourteenth Amendment. In the context of the Due Process Clause, the Supreme Court has determined that, in the area of state taxation, "the simple but controlling question is whether the state has given anything for which it can ask return."[1]

Unfortunately, some state revenue departments have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on businesses located in other states that have little or no connection to their state. Some state revenue departments have even asserted that they can tax a business that merely has customers in the state based on the recently-minted notion of "economic nexus." Such behavior is entirely logical on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state's society. But this country has long stood against such taxation without representation. And worse, the "economic nexus" concept flies in the face of the current state of business activity taxation, which is largely based on the notion that a business should only be subject to tax by a state from which the business receives benefits and protections. And worse still, it creates significant uncertainty that has a chilling effect on interstate economic activity, dampening business expansion and job growth. As a practicing attorney, I regularly advise businesses that ultimately decide not to engage in a particular transaction in another state out of concern that they might become subject to tax liability in that state. It is entirely appropriate for Congress to intervene to prevent individual states from erecting such barriers to trade, and to protect and promote the free flow of commerce between the states for the benefit of the U.S. economy.[2]

Confronted with aggressive – and often constitutionally questionable (as I will discuss in detail later) – efforts of state revenue departments to tax their income when they have little or no presence in the jurisdiction, American businesses are faced with a difficult choice. They can oppose the tax – but then must bear substantial litigation costs to do so. Or, they can knuckle under to the state revenue departments and pay the asserted tax – but then they risk being subject to multiple taxation. Unfortunately, the latter choice is sometimes made, especially since some state revenue departments are making increasing use of "hardball" tactics, a topic on which I would truly relish elaborating at another time or in another forum. Moreover, the compliance burdens of state business activity taxation can be immense. Think of an interstate business with

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

[2] *See e.g.* Diann L. Smith, *Supreme Court Would Uphold P.L. 86-272* (letter to the editors), 25 State Tax Notes 135 (July 8, 2002) (discussing the authority of Congress to regulate interstate commerce).

customers in all 50 states. If economic nexus were the standard, that business would be faced with having to file an income or franchise tax return with every state and pay license or similar taxes to thousands upon thousands of localities.

There can be no doubt that the rapid growth of e-commerce continues to drastically alter the shape of the American and global economies. As businesses adapt to the "new order" of conducting business, efforts by state revenue departments to expand their taxing jurisdiction to cover activities conducted in other jurisdictions constitute a significant burden on the business community's ability to carry on business. Left unchecked, this attempted expansion of the states' taxing power will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation, and uncertainty escalate. Clearly, the time is ripe for Congress to consider when state and local governments should and should not be permitted to require out-of-state businesses to pay business activity taxes. It appears eminently fair and reasonable for Congress to provide relief from unfair and unreasonable impositions of income and franchise taxes on out-of-state businesses that have little or no physical connection with the state or locality.

Consistent with principles enumerated by the majority of the federal Advisory Commission on Electronic Commerce ("ACEC"),[3] and earlier by the Congressional Willis Commission in 1965, the Business Activity Tax Simplification Act is designed to address the issue of when a state should have authority to impose a direct tax on a business that has no or merely a minimal connection with the state. This issue has become increasingly pressing as the U.S. and global economies have become less goods-focused and more service-oriented and as the use of modern technology has proliferated throughout the country and the world. H.R. 3220 applies to state and local business activity taxes, which are direct taxes such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes that are imposed on businesses engaged in interstate commerce. H.R. 3220 does not apply to other taxes, like personal income taxes,[4] gross premium taxes imposed on insurance companies, or transaction taxes measured by gross receipts, such as the New Mexico Gross Receipts and Compensating Tax Act.[5]

The underlying principle of this legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, H.R. 3220 ensures that state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state. H.R. 3220 does so in a manner that ensures that the business community continues to pay its fair share of tax but that puts a stop to new and unfair tax impositions. Perhaps most important, H.R. 3220's physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners. In fact, creating

[3] *See* Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965); and Advisory Commission on Electronic Commerce, "Report to Congress," pp. 17-20 (April 2000), respectively.

[4] In addition, nothing in H.R. 3220 affects the responsibilities of an employer to withhold personal income taxes paid to resident and nonresident employees earning income in a state or to pay employment or unemployment taxes.

[5] N.M. STAT. § 7-9-1 *et seq.*

consistency with the international standards of business taxation is vital to eliminating uncertainty and promoting the growth of the U.S. economy.

Background

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state has been asked for decades.[6] In 1959, the Supreme Court ruled that a corporation with several sales people assigned to an office located in the State of Minnesota could be subjected to that state's direct tax scheme.[7] Prior to that time, there had been a "well-settled rule, stated in *Norton Co. v. Illinois Dept. of Revenue*, 340 U.S. 534 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place."[8] The Supreme Court's 1959 decision in *Northwestern States Portland Cement*, coupled with the Court's refusal to hear two other cases[9] (where the taxpayers, which did not maintain offices in the state, conducted activities in the state that were limited to mere solicitation of orders by visiting salespeople), cast some doubt on that "well-settled rule" and fueled significant concern within the business community that the states could tax out-of-state businesses with unfettered authority, thereby imposing significant costs on businesses and harm to the U.S. economy in general. As a result, Congress responded rapidly, enacting Public Law 86-272 a mere six months later. Public Law 86-272 prohibits states and localities from imposing income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state.[10] Subsequently, the Congressional Willis Commission studied this and other interstate tax issues and concluded that, among other things, a business should not be subject to a direct tax imposition by a state in which it merely had customers.[11]

In recent years, certain states and organizations of state tax collectors have been advocating the position that a state has the right to impose tax on a business that merely has customers there, even if the business has no physical presence in the state whatsoever.[12] The business community, in contrast, believes that a state can impose direct taxes only on businesses

[6] *See, e.g.*, Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 Tax Law. 37 (1987).
[7] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).
[8] *Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).
[9] *Brown Forman Distillers Corp. v. Collector of Revenue*, 101 So.2d 70 (La. 1958), *appeal dismissed and cert. denied*, 359 U.S. 28 (1959); *International Shoe Co. v. Fontenot*, 107 So.2d 640 (La. 1958), *cert. denied*, 359 U.S. 984 (1959).
[10] P.L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).
[11] Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965), Vol. 1, Part VI., ch. 39, 42. *See also* W. Val Oveson, *Lessons in State Tax Simplification*, 2002 State Tax Today 18-39 (Jan. 20, 2002).
[12] A survey conducted by BNA Tax Analysts demonstrates the extent to which the states are asserting the right to impose tax on out-of-state businesses based on so-called "economic nexus" grounds. *Special Report: 2004 Survey of State Tax Departments*, 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-36, S-37 (April 23, 2004). *See also Ensuring the Equity, Integrity and Viability of Multistate Tax Systems*, Multistate Tax Commission Policy Statement 01-2 (October 17, 2002). *Accord* Letter from Elizabeth Harchenko, Director, Oregon Department of Revenue, to Senator Ron Wyden (July 16, 2001). *See also* Doug Sheppard, *The Certainty of Disagreement on Business Activity Tax Nexus*, 25 State Tax Notes 420 (Aug. 5, 2002).

that have a physical presence in the state.[13] While the taxpayers' position has repeatedly been upheld, the state courts and tribunals have rendered non-uniform decisions on this issue.[14] Unfortunately, the Supreme Court has not granted writs of certiorari in relevant cases.[15]

The bottom line is that businesses should pay tax where they *earn* income. It may be true, as certain state tax collectors assert, that without sales there can be no income. While this may make for a nice sound bite, it simply is not relevant. Income is earned where an individual or business entity employs its labor and capital, *i.e.*, where he, she, or it actually performs work.[16] In fact, as early as 1919, the Attorney General of the State of New York pointed out that "the work done, *rather than the person paying for it*, should be regarded as the 'source' of income."[17] For example, suppose an individual spends three years working in his or her home building a new sophisticated machine. To accomplish this, the individual uses a large of amount of equipment and employees in his or her home state. When the inventing, designing, and manufacturing are completed, the individual then engages in a nationwide advertising program to market the sale of the machine. If the ultimate buyer happens to be located in a neighboring state (or for that matter in a state across the country), there is absolutely no reason why the buyer's state should be able to impose tax on the individual selling the item – the individual *earned* the income in his or her home state.

Proponents of the so-called "economic nexus" standard argue that the states provide benefits for the welfare of society as a whole and, therefore, the states should be able to collect business activity taxes from all U.S. businesses, wherever located. Such an argument is not only ludicrous, but it ignores the fact that businesses (and individuals) are members of the American society and pay federal taxes for such general benefits and protections. Nevertheless, some argue that states have spent significant amounts of revenue to maintain an infrastructure for interstate commerce and court systems that the nation can utilize, not to mention spending trillions of dollars over the years to provide education to their populations. This argument continues with the incredible example of the student who benefits from his or her state's education funding who may someday work for an out-of-state company; apparently, the out-of-

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

[14] *See Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003); *A&F Trademark, Inc. v. Tolson*, No. 02-CV-007467 (Wake Co. Super. Ct. 2003); *Acme Royalty Co. v. Missouri Dir. of* Revenue, 2002 Mo. LEXIS 107 (Mo. 2002); *Rylander v. Bandag Licensing Corp.*, Tex. App. Ct., No. 03-99-004217-CV (May 11, 2000); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831, 836 (Tenn. Ct. App. 1999); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

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

[16] As noted by one state tax expert, "'[i]ncome,' we were told long ago, 'may be defined as the gain derived from capital, from labor, or from both combined.'" W. Hellerstein, *On the Proposed Single-Factor Formula in Michigan*, State Tax Notes, Oct. 2, 1995, at 1000 (quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (1920)).

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

state company would then receive benefits that had been provided by that employee's former state and should therefore bear some of the burden by paying tax to the state that provided that education. The absurdity of this position should be clear. Should U.S. companies that have hired people educated in England have to pay taxes to the Queen? Should every business automatically be obligated to pay taxes to all 50 states, in anticipation of the possibility, however remote, that they may at some undefined future point hire a person who was educated in the taxing state? No one can argue that the states do not play an important role in interstate commerce, that an educated public is not an element of a fruitful society and marketplace, or even that a court system does not help to promote order. But this simply cannot be a basis for states to impose tax on all businesses in the nation. Imposing business activity taxes on every out-of-state business is truly "taxation without representation."

The business activity tax concepts in H.R. 3220 are similar to the recommendations of the majority report issued by the Advisory Commission on Electronic Commerce. The ACEC majority report endorsed a nexus standard similar to what was included in prior legislative proposals such as H.R. 2526, 107th Cong. (2001) and S. 664, 107th Cong. (2001). Specifically, the ACEC majority report concluded that a company should have some level of physical presence before a state could impose business activity tax reporting and payment obligations on it and that certain activities would not be considered physical presence for this purpose and specifically carved them out from nexus consideration.[18] Consistent with this conclusion, H.R. 3220 provides for a bright-line physical presence standard that recognizes that certain instances of "presence" are qualitatively *de minimis*.[19] As a result, H.R. 3220 is more conservative and actually provides states with more opportunity to tax interstate commerce than would be available under the ACEC majority report recommendation.

The Business Activity Tax Simplification Act provides simple and identifiable standards that will significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government. It is unlikely that H.R. 3220 will end all controversies, and no statute can ever do that. However, any statute that adds nationwide clarification obviously reduces the amount of controversy and litigation by narrowing the areas of dispute. For example, in the 45 years since its enactment in 1959, Public Law 86-272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense. Recent litigation has focused on what the appropriate nexus standard for business activity taxes actually is; there is no indication that this issue will be settled absent Congressional action.

H.R. 3220's Provisions

Codification of the Physical Presence Standard. H.R. 3220 provides that, pursuant to Congress' Commerce Clause authority, a state or locality may not impose business activity taxes on businesses that do not have a "physical presence" within the jurisdiction. The requisite

[18] *See* Advisory Commission on Electronic Commerce, *Report to Congress*, pp. 21-22 (April 2000).
[19] H.R. 2526 and S. 664 from the previous Congress were drafted "negatively," defining "substantial physical presence" by what it was not, *i.e.*, the activities protected by the safe harbors recommended by the ACEC majority. In response to state revenue departments' criticisms of this "negative" definition, H.R. 3220 was drafted to positively define what is a "physical presence" for purposes of allowing states to impose business activity taxes on out-of-state businesses (among other refinements).

degree of physical presence (employees, property, or the use of third parties to perform certain activities) is set at greater than 21 days during a taxable year, with certain specified incidences of presence being disregarded as qualitatively *de minimis*.

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

There are two exceptions to the 21-day rule that apply to those who really do earn their income during shorter visits to the state. The first exception ensures that businesses engaging in actual selling of tangible personal property through the use of traveling employees, *e.g.*, businesses that hold "tent sales" or "off the truck sales," or in performing certain services to real property in the state through the use of traveling employees, *e.g.*, migrant painters or roofers, are subject to state and local business activity taxes. The second exception is targeted at athletes, musicians, and other entertainers. Such persons are not eligible for the *de minimis* exceptions (and, thus, are subject to tax by the jurisdiction in which they perform). Both of these exceptions are consistent with the underlying intent of H.R. 3220 that businesses pay tax where income is actually earned.

For a qualitative *de minimis* standard, H.R. 3220 provides that certain property or certain activities engaged in by a business' employees within the jurisdiction's boundaries will not be considered in determining whether a business has the requisite physical presence in the jurisdiction. This approach of disregarding certain activities for nexus purposes has already been recognized in Public Law 86-272, where Congress determined that mere solicitation is qualitatively *de minimis* relative to the benefits that protecting such activities offers to the U.S. economy. The protected activities are limited to situations where the business is *patronizing* the local market (*i.e.*, being a customer), and thereby generating economic activity in the state that produces other tax revenues for the state, rather than *exploiting* that market (many states have issued rulings, albeit inconsistent and *ad hoc* in nature, recognizing this principle), including ancillary property and activities. This encompasses visiting current and prospective suppliers, attending conferences, seminars, or media events, utilizing an in-state manufacturer or processor, or having testing performed in the state.

In the area of attributing one business' physical presence in a state to another, H.R. 3220 provides that an out-of-state business will have a physical presence in a state if that business uses the services of an in-state person, on more than 21 days, to perform services that establish or maintain the nonresident business' market in that state, unless the in-state person performs similar functions for more than one business during the year. The ownership relationship between the out-of-state person and the in-state person is irrelevant for purposes of this provision. By limiting attribution of nexus only to situations involving market enhancing activities, H.R. 3220 not only more accurately reflects the economics of a transaction or business, but is also consistent with the current state of the law. Expanding attribution any further would undermine the principles of fairness and equity in taxation. To the extent that a separate company is conducting business in a state, its own income is subject to tax in that state.

As an example, suppose an out-of-state sales company uses an affiliated manufacturer in a state to manufacture a product that the out-of-state business will sell outside of the state of manufacture. The manufacturer is conducting a business activity within the state and there is no doubt that it should be subject to tax by the state. That state will receive tax revenues commensurate with the manufacturing activities that actually occur in the state; the tax revenues will be based on the compensation, set at fair market value, that the manufacturer receives from the out-of-state sales company for its manufacturing services. As for the out-of-state sales company, its selling activities constitute a separate business activity that takes place outside of the state of manufacture. The selling activity generates a certain amount of income (*i.e.*, the sales price of the product less what the selling company paid to the manufacturer for its services) that will be subject to tax in the jurisdictions where the activities actually take place, *i.e.*, where the sales activities add value in the economic stream. Putting this example in a global context, attempts by the state of manufacture to tax the out-of-state sales company would be akin to Taiwan attempting to impose tax on the sales income of every American business that contracts with a Taiwanese manufacturer to make products to be sold in the United States. Clearly, it is simply too attenuated to argue that using the services of the in-state manufacturer subjects the out-of-state business to tax as well.

<u>Modernization of Public Law 86-272</u>. As I mentioned earlier, our economy has undergone significant changes in the 45 years since Public Law 86-272 was enacted. In addition to codifying the physical presence nexus standard, the Business Activity Tax Simplification Act extends the longstanding protections of Public Law 86-272 to *all* sales, not just to sales of tangible personal property, in recognition of those changes, specifically, the change in the focus of the American economy from goods to services and the increased importance of intangible property in the marketplace.

The Business Activity Tax Simplification Act also modernizes Public Law 86-272 by addressing the efforts of some aggressive states to avoid the restrictions imposed by Congress in Public Law 86-272 by establishing taxes on business activity that are measured by means other than the net income of the business. Two examples of these new state business activity taxes are the Michigan Single Business Tax, which imposes a tax on a company's business activities in the state, not on net income, and the New Jersey Corporation Business Tax, which was amended effective in 2002 to impose a gross profits/gross receipts tax. What is most distressing about the New Jersey amendments is that, after June 2006, these "gross" taxes will apply *only* to businesses protected by Public Law 86-272. In other words, New Jersey has effectively circumvented the congressional policy decision underlying the enactment of Public Law 86-272 by imposing a non-income tax only on those businesses that would otherwise be protected by the Public Law. While other states may not enact such a targeted end-run around Public Law 86-272, it is likely that states will increasingly turn to non-income based business activity taxes, especially in light of the states' current fiscal situations. For example, last year, Kentucky's Governor Paul Patton proposed a budget that would replace Kentucky's corporate income tax with a "business activity tax" that would tax a company's payroll paid in Kentucky and gross receipts from sales in Kentucky, even those of out-of-state businesses.[20] While the Kentucky legislature ultimately did not adopt Governor Patton's budget, non-income business activity taxes have clearly become an alternative that more states have begun to consider seriously. H.R. 3220 addresses this by ensuring that Public Law 86-272 covers *all* business activity taxes, not just net income taxes.

Federalism

Contrary to the arguments of some opponents of clarifying standards for state business activity taxes, considerations of federalism support passing this legislation. As discussed earlier, the Founding Fathers, by discarding the Articles of Confederation and establishing a single national economy, intended for Congress to protect the free flow of commerce among the states against efforts by individual states to set up barriers to this trade. Congress itself has recognized this numerous times in the context of state taxation and has exercised its responsibilities repeatedly by enacting laws that limit the states' authority to impose taxes that would unreasonably burden interstate commerce. Of course, there is the obvious precedent of Public Law 86-272, the statute that H.R. 3220 would modernize. A few other examples include:[21]

> – the Federal Aviation Act, which prohibits states and localities from levying a ticket tax, head charge, or gross receipts tax on individuals traveling by air; provides that airline employees may be taxed only in their state of residence and the state in which they perform at least fifty percent of their duties; allows only states in which an aircraft takes off or lands to tax the aircraft or an activity or service on the aircraft; and prohibits state "flyover" taxes;
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> – the Mobile Telecommunications Sourcing Act, which prohibits states from taxing mobile telecommunications service unless the state is the user's place of primary use of the service;
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> – the Amtrak Reauthorization Act of 1997, which prohibits states from taxing Amtrak ticket sales or gross receipts;
>
> – Public Law 104-95, which prohibits states from taxing pension income unless the pensioner resides in that state;
>
> – the ICC Termination Act of 1995, which prohibits states from taxing interstate bus tickets;
>
> – the Miscellaneous Revenue Act of 1981, which prohibits states and localities from imposing property taxes on air carriers' property at a higher rate than that which is imposed on other commercial or industrial property in the state;

[20] *See Securing Kentucky's Future*, State of Kentucky, Office of the State Budget Director (January 2003).

[21] For a detailed list of instances where Congress has exercised its authority under the Commerce Clause, *see* Frank Shafroth, *The Road Since Philadelphia*, 30 State Tax Notes 155 (October 13, 2003).

– the Railroad Regulatory Reform and Revitalization Act of 1976 (the "4R Act"), which prohibits states from imposing differing taxes on railroad property;[22] and

– the Soldiers and Sailors Civil Relief Act of 1940, which limits state taxation of members of the Armed Forces to the member's state of residence, prohibiting different states in which the member may be stationed from also taxing that member.

There is a definite tension between a state's authority to tax and the authority of Congress to regulate interstate commerce. However, the very adoption of the Constitution was itself a backlash against the ability of states to impede commerce between the states; in adopting the Constitution, which expressly grants Congress the authority to regulate interstate commerce, the states relinquished a portion of their sovereignty.[23] Moreover, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[24]

H.R. 3220 strikes the correct balance between state autonomy/sovereignty and the regulation of interstate commerce. H.R. 3220 merely codifies current jurisdictional standards for *when* a business may impose a tax; the bill does nothing to determine *how* a state may tax businesses that are properly subject to its taxing jurisdiction. A state remains free to determine what type of tax to impose, be it an income tax, a gross receipts tax, a value added tax, or a capital stock tax; to determine how to apportion the income that is taxed in the state, be it a single- or three-factor formula based on property, payroll and/or sales; to set the rate at which the tax chosen will be imposed; to determine whether or not to follow federal taxable income, *e.g.*, to choose whether to decouple from federal bonus depreciation; to provide credits or deductions for certain types of expenses; and so on.

On the other hand, the economic nexus standard (*i.e.*, establishing the requisite nexus based solely on a business having a customer in the taxing jurisdiction) asserts that a business is liable for a business activity tax if that business has derived revenue or income from a customer in a state – even though the business has conducted no activities in the state (*i.e.*, has had no property or employees located in that state). Keeping in mind that every buyer in a transaction in a free market economy benefits from the transaction as much as the seller, the economic nexus standard effectively imposes a toll charge on out-of-state businesses for exchanging cash for property (or for the provision of a service). Such a tax acts as a tariff on interstate commerce and creates exactly the problem that existed under the Articles of Confederation and that led to the adoption of the Constitution. Under the Articles of Confederation, state taxes and duties impeded interstate commerce as states began enacting their own tariffs and taxing interstate

[22] In fact, the United States District Court for the District of Wyoming recently determined that Wyoming's coal transportation tax singles out and discriminates against railroads in violation of the 4R Act. *Burlington N. and Santa Fe Ry. Co. v. Atwood*, D. Wyo., No. 00-CV-108-J, slip op. (D. Wyo. 2003).
[23] *See* Adam D. Thierer. *A Delicate Balance: Federalism, Interstate Commerce, and Economic Freedom in the Technological Age*, The Heritage Foundation (1998) (citing Alexander Hamilton, *Federalist No. 22*).
[24] *Barclay's Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). *See also* Eugene F. Corrigan, *Searching for the Truth*, 26 State Tax Notes 677, (Dec. 9, 2002) ("No amount of state legislation of any kind can extend a state's taxing jurisdiction beyond the limits set by the Supreme Court; and that Court has, for all practical purposes, washed its hands of the matter, deferring it to Congress.")

commerce, thereby putting up trade barriers to free trade.[25] This led to some states retaliating by banning products from other states. By effectively imposing such toll charges, the economic nexus standard would clearly have a negative impact on interstate commerce.

Comparison to Current Common Law

The physical presence nexus standard in H.R. 3220 is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Constitution's Due Process Clause and its Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus" between the taxing state and a putative taxpayer for all state taxes, whereas the Due Process Clause requires only a "minimum" connection. In *Quill*, the Supreme Court determined, in the context of a business collecting sales and use taxes from its customers, that the substantial nexus requirement could be satisfied only by the taxpayer having a physical presence in the state; the Court refrained from articulating the appropriate measure for business activity taxes.[26] This is because under the American legal system, a court only has the authority and responsibility to address the case before it. The Supreme Court has not granted a writ of *certiorari* for a case that would permit it to address the business activity tax nexus issue. So what constitutes substantial nexus for business activity taxes?[27]

Since the Court has not yet ruled on this issue, we must use clear logic and review what state courts and tribunals have recently decided. The answer is clear: if non-*de minimis* physical presence is the test for a mere collection and remission situation such as is the case for sales and use taxes, physical presence must be, at a bare minimum, the appropriate test for the imposition of business activity taxes. Indeed, the standard for business activity taxes should, if anything, be *higher* than the standard for sales taxes for at least two reasons. First, a business activity tax is an actual direct tax (and not a mere obligation to collect tax from someone else) and the consequent greater economic burden should require a greater connection (as the Supreme Court seems to have recognized in *National Geographic Society v. Board of Equalization*).[28] Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes. Sales and use taxes typically involve only two jurisdictions (the state of origin and the state of destination). However, corporate business activities often create contacts with many states. Most of the state-level decisions on this issue have concluded that there is no principled reason for there to be any

[25] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 11 (1824); *Quill v. North Dakota*, 504 U.S. 298, 313 (1992).
[26] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[27] Opponents of a physical presence standard cite *International Harvester*, a 1944 United States Supreme Court case, as support for their position that economic nexus is appropriate. *See International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944). Reliance on this case is simply not appropriate because to do so ignores a full 60 years of subsequent jurisprudence (*e.g.*, *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977) and *Quill*). But even more fundamentally, the case involved a Due Process analysis and never considered the requirements of the Commerce Clause. In addition, when read in the proper context, it is clear that *International Harvester* does not endorse an economic presence standard for business activity taxes. In fact, *International Harvester* concerned the ability of Wisconsin to require a corporation with a physical presence in the state to withhold tax on dividends that it paid to its shareholders. Further, the imposition of liability on the corporation can be seen as merely a delayed income tax on the physically present corporation. Clearly, this case is not to be relied upon to determine the appropriate nexus standard for business activity taxes.
[28] *National Geographic Society v. Board of Equalization*, 430 U.S. 551 (1977).

lower standard for business activity taxes than for sales and use taxes.[29] Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.

Effect on State Revenues

There simply is no basis for any contention that H.R. 3220 could lead to any significant loss of state revenues. H.R. 3220 does not depart to any significant degree from what is now being done in the states. This has recently been confirmed by the former executive director of the Multistate Tax Commission.[30] Outside the context of passive investment companies,[31] state revenue departments simply have not been successful in their attempts to assert economic nexus to impose tax on businesses that do not have a physical presence in the state.

H.R. 3220 would have no effect on taxes derived from businesses that maintain a facility in the jurisdiction for more than 21 days during the taxable year. Clearly, state and local governments derive most – if not virtually all – of their business activity tax revenue from such businesses. The amount of revenue received by taxing jurisdictions from those businesses that maintain no office, store, warehouse, or other facility – or even inventory – in the jurisdiction at all must truly be minimal.

Consider first states that impose a net income tax to which Public Law 86-272 applies. It is difficult for tax practitioners, corporate tax managers, and several government officials that were queried to believe that these states are actually collecting any material amount of revenue from businesses that have no office in the state and have non-solicitation employees in the state for zero to 21 days during the year. There simply cannot be many businesses paying such taxes and, thus, any revenue loss would be negligible.

Consider next those states, such as Michigan, New Jersey, Texas, and Washington, that impose business activity taxes that are not solely based on net income and, thus, are not covered by Public Law 86-272. These states are currently able to collect revenue from out-of-state businesses that do not themselves maintain an office or other facility in the state but that employ individuals in the state who perform solicitation in that state. Modernizing Public Law 86-272 to

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[29] This includes *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *America Online v. Johnson*, No. 97-3786-III, Tenn. Chancery Ct. (Mar. 13, 2001); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995), *reh'g denied*, 1996 Ala. Tax LEXIS 17 (Ala Dep't of Revenue Jan. 29, 1996) (*But see Lanzi v. State of Alabama Department of Revenue*, Ala. Dep't of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003)).

[30] "It seems to me that the states need to face the reality that most of them are generally incapable of enforcing the 'doing business' standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway." Eugene Corrigan, *States Should Consider Trade-Off on Remote-Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

[31] It is interesting to note that the states have now moved on to using other, more effective attacks against passive investment companies, such as the economic substance and *alter ego* arguments, combined reporting, and the denial of the relevant deductions. *See* Mitchell J. Tropin, *States Moving Away From 'Geoffrey,' Using Sham Arguments, 'Attribution' Nexus*, Daily Tax Report, No. 27 (Feb. 10, 2003).

cover non-income taxes clearly means that such states will no longer be able to collect this revenue. The amount of tax paid by such businesses, however, again must be minimal because it is unlikely that businesses are paying business activity tax to states in which they only have a fleeting presence.

It is essential to keep in mind that H.R. 3220 is based on the principle that a business engaged in interstate commerce should pay its fair share of tax.[32] H.R. 3220 does not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the correct jurisdiction.

While on the topic of revenue impact, I would like to address the assertions of critics of the bill that H.R. 3220 would create significant revenue losses to the states.[33] As I just explained, it simply cannot be the case that H.R. 3220 would have more than a negligible revenue impact to the states. Charges by critics that the bill would have a significant fiscal effect are simply masking what is really going on, *i.e.*, that state revenue departments and their representatives do not want any legislative constraints on or oversight of their taxing authority – even when the legislative constraints are squarely within Congress' authority to regulate interstate commerce.

Moreover, the statements of revenue impact made by certain state revenue departments and their representatives have been shown to be highly unreliable because the "estimates" focus on *potential* effects from *hypothetical* restructurings by businesses, are based on *hypothetical* changes in state law, or cite to *potential* impacts on apportionment rules (which is an issue of how much to tax, not whether to tax). Such considerations do not make for a reliable or accurate revenue estimate; proper revenue estimates are based on revenues currently collected. In reality, there simply will be no material effect on the amount of revenue received by the states because H.R. 3220 seeks to maintain the status quo.

[32] A recent study commissioned by the Council on State Taxation found that businesses (not including pass-through entities) paid $378.9 billion in state and local taxes in 2002, an amount that was considered to be at least business' fair share of tax. *See* Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, *A Closer Examination of the Total State and Local Business Tax Burden*, 27 State Tax Notes 295 (Jan. 27, 2003).

[33] It is interesting that critics of proposals that address multistate taxation always counter with claims that the proposal will cause significant revenue loss to the states. *See, e.g., Corporate Tax Sheltering and The Impact On State Corporate Income Tax Revenue Collections,* Multistate Tax Commission (July 25, 2003); Dan Bucks, Elliott Dubin and Ken Beier, *Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act*, Multistate Tax Commission (Sept. 24, 2003); Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, Center on Budget and Policy Priorities (October 20, 2003). Yet there is no reliable empirical evidence that states have actually lost revenue when measures affecting state taxation have been enacted. This certainly goes to the credibility (or lack thereof) of such claims. As an example of the unreliability of such claims, the National Conference of State Legislatures has expressed its concern over projections by some national organizations that the inclusion of telecommunications services in the Internet tax moratorium would cost the states $22 billion each year (an estimate representing the total revenue from all state and local telecommunication taxes in the 50 states from 1992); in a letter to Senator Alexander dated November 5, 2003, the Congressional Budget Office estimated that the actual revenue cost would be between $80 million and $120 million per year starting in 2007 – an estimate that is approximately 220 times smaller. *Accord* Congressional Budget Office Cost Estimate, H.R. 49, Internet Tax Nondiscrimination Act, as requested by the House Comm. on the Judiciary (July 21, 2003). In a November 4, 2003 action alert regarding S. 150, "The Internet Tax Non-Discrimination Act," the NCSL stated that "[t]he $20 billion estimation runs counter to expressed congressional intent and the provisions of the Manager's amendment and as a result threatens to seriously harm the credibility of state governments before Congress and the Administration."

Effect on International Taxation and American Competitiveness

Our country's own history and the federal government's position in the context of international taxation provide sufficient reason to establish a physical presence nexus standard. The United States and its tax treaty partners have, for decades, adopted and implemented a "permanent establishment" rule. The "permanent establishment" concept is a long-standing principle and has been extremely important to U.S. businesses and, thus, to the U.S. economy.

The "permanent establishment" rule provides that neither country that is a party to the treaty will impose an income tax on a business from the other country unless that business maintains a substantial physical presence in the taxing country. Using the U.S. Model Treaty provisions as an example, a foreign business must have a "fixed place of business [in the United States] through which the business of an enterprise is wholly or partly carried on" before the United States may impose a tax on that business.[34] Under this standard, neither a "rep office" staffed by a few people, nor a facility used for storage, nor the maintenance of goods or merchandise for processing by another business would rise to the level of being a "permanent establishment" in the United States sufficient for the imposition of federal income tax on that business.

A physical presence standard places an appropriate limit on states gaining taxation powers over out-of-state firms and conforms to common sense notions of fair play. It is significant that the OECD has recently studied the issue and preliminarily concluded that the "permanent establishment" rule should remain the proper standard for international tax treaties even with the proliferation of electronic commerce.[35] The policy reasons underlying such a conclusion are clear. Imagine for a moment that a foreign country tried to tax the profits of U.S. companies simply because the U.S. firms exported goods into that country. There is no doubt that the United States government and business community would be outraged. However, the economic nexus standard that the states would like to implement would have a similar effect on interstate commerce.

Unfortunately, it has been said that some smaller countries, citing the efforts of U.S. state revenue departments to impose direct taxes on any business that has customers within the state's borders, are now saying that they want to renegotiate their treaties with the United States so they can begin taxing every U.S. business that has a customer in their country. This would be a disaster for the U.S. economy. Enactment of H.R. 3220, 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.

Interplay with State Tax Incentives

In recent years, states have been increasingly active (and competitive) in offering tax incentive packages to businesses to locate and/or expand their operations in that state. Such incentives are offered not only to entice businesses into a state but also to ensure that businesses

[34] United States Model Income Tax Convention of September 20, 1996, Art. 5.
[35] *See Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?*, Organisation for Economic Co-operation and Development, Technical Advisory Group on Monitoring the Application of Existing Treaty Norms For Taxing Business Profits, Public Discussion Draft (Nov. 26, 2003).

already located in the state do not relocate to, or expand in, other jurisdictions. The in-state company receives the benefits and protections provided by the state and, absent the incentives, would therefore be properly subject to full taxation.

A less obvious tax incentive occurs when states adopt apportionment formulas that weight the sales factor more heavily than the property and payroll factors. If a state has a double-weighted sales factor or a single-factor apportionment formula based only on sales (which is increasingly popular among the states), in-state businesses enjoy a significant benefit over businesses that have little or no property or payroll in the state but that do have sales that are apportionable to the taxing state.

When combined with the economic nexus standard, states would actually be subsidizing such incentives for in-state businesses at the expense of out-of-state businesses that do not receive the benefits and protections provided by the state. Not only does this offend the basic principle of nondiscrimination that is required by the Commerce Clause of the U.S. Constitution,[36] but, in addition, it surely is misguided tax policy to make one party that is not really "in" the jurisdiction bear the tax burden of those persons who actually receive the benefits and protections of the government services that the taxes are funding.

Effect on American Job Retention and Growth

The U.S. economy has been making strong gains in the overall level of growth, with historically low inflation, home ownership at record levels, and household consumption expanding. These economic gains have been due in large part to the ongoing expansion in the productivity of U.S. workers and businesses. While productivity gains are unquestionably a good thing for the U.S. economy, the flip side is that U.S. businesses have proven capable of increasing output without expanding employment at the same rate as seen in most past recoveries. Therefore, responsible federal policymakers need to identify and rectify potential barriers to new job creation in America to ensure that our economic expansion creates the largest number of high-quality jobs.

The current level of uncertainty and ambiguity in the application of state-level taxes on U.S.-based businesses impedes new job creation. Businesses operating in the U.S. must deal with the ambiguity in the current nexus rules that govern when states have the right to impose direct taxes on businesses. Rather than a clear set of federal rules regarding when a business is subject to state taxes, the current environment is governed largely by the level of aggressiveness of state tax administrators and ongoing litigation. As I mentioned earlier, state tax officials have increasingly pushed the envelope in an effort to raise revenues from out-of-state enterprises. The uncertainty will only increase as states continue to assert jurisdiction over out-of-state businesses based on "economic nexus" principles.

It is noteworthy that this uncertainty is borne chiefly by businesses based in the United States. Investing in the creation of new plants, equipment, and jobs in other countries is actually encouraged by the ambiguity in nexus standards and the aggressiveness of state tax officials. When combined with the effect of bilateral tax treaties and the difficulty of collecting state-level

[36] *See, e.g., Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984).

taxes from foreign enterprises, the uncertainty and ambiguity of state taxation has become another incentive that unnecessarily promotes new investment and job creation abroad.

Foreign business enterprises are often shocked to learn that while treaties may insulate them from federal taxation, state taxation can still be imposed. This factor, when combined with the ambiguity of current state tax nexus law and the aggressiveness of state tax administrators, has put a real damper on foreign investment. Even when a foreign business initially considers opening an active business in the United States and paying federal tax and state tax where it locates its property and employees, the specter of having to pay tax to every jurisdiction where it merely has customers is quite intimidating. Addressing the problems of state tax uncertainty and the risk of litigation costs clearly has the potential to encourage additional foreign investment in the U.S., thus creating new jobs throughout the country.

By providing a bright line, quantifiable physical presence standard, H.R. 3220 addresses the current level of uncertainty in the nexus rules that apply to direct business taxes by lowering litigation expenses for companies that operate facilities in the United States and by reducing the likelihood that they will be targeted by out-of-state tax authorities bent on raising revenues from businesses that do not have a presence in their state. H.R. 3220, while certainly not an answer to all the questions related to encouraging new job creation in America, will encourage businesses, whether based in America or overseas, to put new investment and create new jobs here in America rather than in another country.

Conclusion

The physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy[37] and that is consistent with Public Law 86-272, a time-tested and valid Congressional policy. Physical presence is an accepted standard for determining nexus.[38] And a physical presence test for nexus is consistent with the established principle that a tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer.

What the entire nexus issue boils down to is fairness. The bright-line physical presence nexus standard of H.R. 3220 provides the most fair and equitable standard. This is true primarily for two reasons. One, businesses have a reasonable expectation of taxation only when they are the recipients of the benefits and protections provided by the taxing jurisdiction. Two, a physical presence standard protects in-state businesses from "foreign tax" imposed by jurisdictions solely because of the business having customers located in the taxing jurisdiction. By providing clarity, the physical presence standard removes an impediment to investment in the United States. For

[37] Richard Pomp, who testified as a tax policy expert on behalf of the taxpayer in *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), articulated "six principles of tax policy . . . as representing the values inherent in the commerce clause: desirability of a clear or "bright-line" test, consistency with settled expectations, reduction of litigation and promotion of interstate investment, non-discriminatory treatment of the service sector, avoidance of multiple taxation, and efficiency of administration." *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 at 15-16 (Oct. 23, 2003). Professor Pomp concluded that a physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.* at 16.

[38] *See, e.g., Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

these reasons, the bill would benefit both U.S. businesses and consumers and, thus, the U.S. economy as a whole.

My comments only scratch the surface of why a physical presence nexus standard for business activity taxes and modernization of Public Law 86-272 is the right answer and why H.R. 3220 should therefore be enacted. But it is clear that H.R. 3220 warrants the full and enthusiastic support of the Subcommittee. Its enactment will ensure that the U.S. business community, and thus the U.S. economy, are not unduly burdened by unfair attempts at taxation without representation. H.R. 3220 will not cause any dislocations in any state's revenue sources. Thank you for your time, I welcome any questions.

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Mr. CANNON. Thank you, Mr. Rosen.
Mr. Van Fossen.

STATEMENT OF JAMIE VAN FOSSEN, STATE REPRESENTATIVE, 81ST HOUSE DISTRICT, STATE OF IOWA

Mr. VAN FOSSEN. Chairman Cannon, Representative Watt, and Members of the Subcommittee, thank you for the opportunity to testify today. My name is Jamie Van Fossen, and I am a State Representative from Iowa, and I chair the House Ways and Means Committee at the State House. I also serve as a public sector chair for the Tax and Fiscal Policy Task Force at the American Legislative Exchange Council, or ALEC.

On behalf of the people of Iowa and the over 2,400 State legislator members of ALEC, I am pleased to testify in support of H.R. 3220, or BATSA, legislation. ALEC is a bipartisan individual membership organization of over 2,400 State legislators. ALEC's mission is to promote Jeffersonian principles of free markets, individual liberty and federalism and limited government. Our task force mission is to study efforts of legislators from across the country and assist them in their lawmaking function. We author and study model legislation with the assistance of our private sector members on issues ranging from tax limitation to managing a State budget crisis, and also to the relationship between State tax policy and interstate commerce.

Last year we took notice of a disturbing trend in State tax policy, the erosion of the physical presence standard for the collection of business activity taxes. The State revenue departments spurred on by a State budget crises are moving more aggressively to collect taxes from businesses wholly located in other States. In response to this trend and the threat it created for interstate commerce and State economic growth, ALEC provided two pieces of model legislation designed to preserve and strengthen the physical presence or nexus requirement for imposition of business activities tax.

We first passed a model resolution calling on Congress to retain and strengthen Public Law 86–272 as the Federal standard for the State imposition of business activities tax. In our resolution we said that the ability of State and local jurisdictions to tax out-of-State businesses should be limited to those situations in which the business has employees and/or property in a taxing jurisdiction and, accordingly, receives meaningful Government benefits or protections from this jurisdiction.

Our resolution also asks Congress to update Public Law 86–272 by extending its protections beyond solicitation of sales of tangible personal property to the sales of services and intangibles, therefore reflecting the realities of 21st century economy. We then presented a model bill that would make physical presence the State standard for imposing business activities taxes. The model also defines physical presence in a way that would create certainty for businesses and minimize costly litigation on nexus issues. The bill would have provided a de minimis threshold of 21 days of physical presence in a State before taxation would be triggered. Our model bill has been introduced in California, in Iowa, and also has been introduced in Wisconsin.

Our model resolution was approved by the Iowa House of Representatives last month as you mentioned, Mr. Chairman. I urge you to support the simplification of business activities tax for several reasons: First, because it is consistent with constitutional separation of powers between Federal and State governments; second, because it would contribute to State economic growth and job creation; and, third, because it would maintain the principle of tax competition among the States.

I believe as does ALEC that Government powers should be limited. This same belief animated the drafters of the Declaration of Independence and the Constitution of the United States and should be at the forefront of our thinking in any discussion about interstate commerce and State tax jurisdiction.

H.R. 3220 is consistent with this core belief because it would limit power of State government to place undue burdens on interstate commerce. People are often surprised to learn that ALEC, a State focused public policy group, is in favor of Federal restrictions on State power. They wonder how we could be in favor of federalism and also advocate for Federal preemption of certain State tax on business activities. The answer is simple, federalism is not an end into itself. Federalism, like the separation of powers, is the tool we use to limit Government's power and enhance the liberty of our citizens. Whenever State government goes beyond its powers given to it by the people and the Constitution, such as when the State tries to impose business taxes located outside of the State's jurisdiction, we should not hide behind the mantra of federalism and excuse the action.

H.R. 3220 is thus not about the rights of States. It is about the rights of people. This bill is not about the right of Iowa and other States to maintain historic levels of spending on schools, health care and transportation. This bill is about the rights of Iowa business owners and their customers to engage in interstate commerce free from the undue burdens associated with paying taxes in multiple States. You are not forced, as opponents of the bill claims, to choose between public schools and other funding. You are going to have to decide whether federalism means that States have nearly unlimited powers to tax or whether federalism is just as much a restriction on State power as it is a restriction on Federal power.

H.R. 3220 is also consistent with the time honored American principle of no taxation without representation. Businesses should not have to pay taxes in those jurisdictions where they have no physical presence, where they derive to substantial benefit from the services of Government, and where they have no lasting connection of betterment of culture and society.

This leads me to the second reason I and ALEC support H.R. 3220, because it will foster economic growth and job creation, especially at the State level. We should measure fiscal health of a State by the gross State product, State jobs and the size of the family budget. We should not measure fiscal health by the size and growth of the State budget or State revenues. This will in turn be good for the viability of State finances. Any threat to our national economy is by definition a threat to the States. Enacting legislation like H.R. 3220 is the best medicine Congress can prescribe for healthy State economies.

H.R. 3220 would also maintain, and I think this gets to the point, a healthy tax competition among States. In Iowa we seek to create a tax and regulatory environment that is favorable to business locations and job creation. We compete with other States to offer the beneficial place to locate business. If other States can tax Iowa businesses merely because they have customers that derive income from those States, Iowa will lose a major tool we have to attract business and jobs.

Thank you.

[The prepared statement of Mr. Van Fossen follows:]

PREPARED STATEMENT OF JAMIE VAN FOSSEN

Chairman Cannon, Representative Watt, and members of the subcommittee, thank you for the opportunity to testify before the House Judiciary Subcommittee on Commercial and Administrative Law. My name is Jamie Van Fossen, and I am a State Representative from Iowa. I chair the Iowa House Ways and Means Committee and I also serve as the public sector chair of the Tax and Fiscal Policy Task Force at the American Legislative Exchange Council (ALEC). On behalf of the people of Iowa, and the over 2,400 state legislative members of ALEC, I am pleased to testify in support of H.R. 3220, the "Business Activity Tax Simplification Act of 2003."

ALEC is a bi-partisan, individual membership organization of over 2,400 state legislators. ALEC's mission is to promote the Jeffersonian principles of free markets, individual liberty, federalism and limited government to our members. I serve as the public sector chair of the Tax & Fiscal Policy Task Force. Our task force's mission is to study the efforts of legislators from across the country and assist them in their lawmaking function. We author and study model legislation, with the assistance of our private sector members, on issues ranging from tax limitation, to managing a state budget crisis, to the relationship between state tax policy and interstate commerce.

Last year, we took notice of a disturbing trend in state tax policy: the erosion of the physical presence standard for the collection of business activity taxes. State revenue departments, spurred on by the state budget crisis, are moving more aggressively to collect taxes from businesses wholly located in other states. In response to this trend and the threat it created for interstate commerce and state economic growth, ALEC approved two pieces of model legislation designed to preserve and strengthen the physical presence nexus requirement for the imposition of business activity taxes.

We first passed a model resolution calling on Congress to retain and strengthen Public Law 86–272 as the federal standard for the state imposition of business activity taxes. In our resolution, we said that the ability of state and local jurisdictions to tax out-of-state businesses should be limited to those situations in which the business has employees and/or property in the taxing jurisdiction and accordingly receives meaningful governmental benefits or protections from the jurisdiction. Our resolution also asks Congress to update Public Law 86–272 by extending its protections beyond the solicitation of sales of tangible personal property to the sales of services and intangibles, thereby reflecting the realities of the 21st century economy.

We then passed a model bill that would make physical presence the state standard for imposing business activity taxes. The model also defines physical presence in a way that would create certainty for businesses and minimize costly litigation on nexus issues. The bill would provide a de minimis threshold of 21 days of physical presence in a state before taxation would be triggered. Our model bill has been introduced in California and Iowa, and we expect it to be introduced shortly in Wisconsin. Our model resolution was approved by the Iowa House of Representatives last month.

I urge you to support the simplification of business activity taxes for several reasons: first, because it is consistent with the constitutional separation of powers between the federal and state governments; second, because it would contribute to state economic growth and job creation, and; third, because it will maintain the principle of tax competition among the states.

I believe, as does ALEC, that government's power should be limited. This same belief animated the drafters of the Declaration of Independence and the Constitution of the United States, and should be at the forefront of our thinking in any discussion about interstate commerce and state tax jurisdiction. H.R. 3220 is consistent with this core belief because it would limit the power of state government to place undue burdens on interstate commerce. People are often surprised to learn that ALEC—a state-focused public policy group—is in favor of federal restrictions on state tax power. They wonder how we can be in favor of federalism and also advocate for federal preemption of certain state taxes on business activities. The answer is simple: federalism is not an end unto itself. Federalism, like the separation of powers, is a tool we use to limit government's power and enhance the liberty of our citizens. Whenever state government goes beyond the powers given to it by the people and the Constitution, such as when a state tries to impose taxes on businesses located outside its jurisdiction, we should not hide behind the mantra of federalism and excuse such action.

H.R. 3220 is thus not about the rights of the states, it is about the rights of the people. This bill is not about the right of Iowa and other states to maintain historic levels of spending on schools, health care and transportation. This bill is about the rights of Iowa business owners and their customers to engage in interstate commerce free from the undue burdens associated with paying taxes in multiple states. You are not forced, as the opponents of this bill claim, to choose between public schools and corporate profits. Rather, you are going to decide whether federalism is a two way street, granting license to states as well as restricting state power outside its own borders. You are going to have to decide whether federalism means that states have nearly unlimited powers to tax, or whether federalism is just as much a restriction on state power as it is a restriction on federal power.

H.R. 3220 is also consistent with the time-honored American principle of "no taxation without representation." Businesses should not have to pay taxes in those jurisdictions where they have no physical presence, where they derive no substantial benefit from the services of government, and where they have no lasting connection to the betterment of the culture and society. If we do not draw the line at physical presence, it will be difficult to draw it anywhere that would meaningfully limit the state's power to place undue burdens on interstate commerce. The number of states in which a business will have to pay taxes will quickly multiply, indeed is already multiplying, because of the erosion of the physical presence standard and the need to extend the standard to sellers of services and intangibles.

This leads me to the second reason I, and ALEC, support H.R. 3220: because it will foster economic growth and job creation, especially at the state level. We should measure fiscal health by the growth in Gross State Product (GSP), state jobs, and the size of the family budget. We should not measure fiscal health by the size and growth of the state budget or state revenues. This bill will be good for economic growth because it will promote the free flow of interstate commerce and create certainty for businesses engaged in interstate commerce. This will in turn be good for the viability of state finances. Any threat to our national economy is by definition a threat to the states. Enacting legislation like H.R. 3220 is the best medicine Congress can prescribe for healthy state economies.

H.R. 3220 would also maintain healthy tax competition among the states. In Iowa, we seek to create a tax and regulatory environment that is favorable to business location and job creation. We compete with other states to offer the most beneficial place to locate a business. This tax competition is healthy for Iowa and healthy for our national economy. If other states can tax Iowa businesses merely because they have customers or derive income in those states, Iowa will lose a major tool we use to attract jobs and businesses.

Iowa has been a leader in the effort to reform and simplify business activity taxes. As I mentioned earlier, the Iowa House of Representatives passed a resolution last month calling on Congress to enact business activity reforms similar to H.R. 3220. As a state lawmaker, I would urge you to enact H.R. 3220 because it promotes federalism, enhances our national economy and thereby increases the financial viability of our state governments, and preserves the constitutional principle of tax competition among the states. Thank you.

STATE OF IOWA

GENERAL ASSEMBLY

HOUSE RESOLUTION NO. 164

BY J. K. VAN FOSSEN

A Resolution requesting the United States Congress to expand the physical presence standard for the imposition of state and local business activity taxes.

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

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

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

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

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

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

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

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

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

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

WHEREAS, the United States economy has become more global since Congress first enacted Pub. L. No. 86-272 and has shifted toward the provision of more interstate services and intangibles, and providers of services and intangibles are competitively disadvantaged relative to businesses that only sell tangible personal property; and

WHEREAS, the enactment of new business activity taxes other than income taxes threatens to circumvent the intent of Congress in enacting Pub. L. No. 86-272; NOW THEREFORE,

BE IT RESOLVED BY THE HOUSE OF REPRESENTATIVES, That the State of Iowa urges Congress to enact legislation recognizing a physical presence standard for the imposition of state and local business activity taxes, defining de minimis standards for measuring physical presence and setting reasonable limits on the attribution of nexus, and updating Pub. L. No. 86-272 to extend the current protections available for the solicitation for sales of goods to the solicitation for sales of services and intangibles and to apply these protections to all business activity taxes; and

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

BE IT FURTHER RESOLVED, That the Chief Clerk of the House of Representatives shall forward a copy of this Resolution to the Congress of the United States.

We, Christopher Rants, Speaker of the House and Margaret Thomson, Chief Clerk of the House, hereby certify that the above and foregoing Resolution was adopted by the House of Representatives of the Eightieth General Assembly.

Christopher Rants
Speaker of the House

Margaret Thomson
Chief Clerk of the House

Mr. CANNON. Thank you, Mr. Van Fossen. I would like to point out, in a day when we are hearing claims of outsourcing, if Iowa loses job it is likely that America loses jobs.

Commissioner Clayburgh.

STATEMENT OF RICK CLAYBURGH, TAX COMMISSIONER, STATE OF NORTH DAKOTA

Mr. CLAYBURGH. Thank you, Mr. Cannon. Chairman Cannon, Mr. Watt, Members of the Subcommittee, I am Rick Clayburgh, the Commissioner of North Dakota's Office of State Tax Commission. I am speaking to you today on behalf of the National Governors' Association, and thank you for the opportunity to address the issues relating to H.R. 3220, the Business Activity Tax Simplification Act, and the impact that it could have on all States.

I would like to read a couple of points out of my testimony, but you do have a copy of my testimony, and then I would just like to address some issues.

First of all, I would like to reiterate the National Governors' Association policy on this issue of business activity tax, which is very clear. The National Governor's Association opposes any further legislative restriction on the ability of States to determine their own policy on business activity or corporate profit taxes. This is an issue of State sovereignty. The U.S. Constitution adequately protects the interests of both States and business. The National Governors' Association opposes H.R. 3220 because it would unduly interfere with the ability of States to determine and manage its own policies.

Members of the Committee, the issues that we are facing are difficult in many respects. As you look at businesses, they are entities that are legal fictions that are created on paper and that have no physical being. These businesses are present in States through representatives such as buildings, property or inventory they own or persons they hire such as employees and independent contractors that do the company's work. They are present in States through activities they undertake such as leasing, contracting, licensing, selling and the like. So the key question that we face is what are the activities of a company that have no single physical embodiment sufficient to bring it within a State's taxing jurisdiction.

The National Governors' Association is opposed to H.R. 3220 based on five key points. First of all, it encourages and expands tax planning. One of the issues that has come up within States is the ability of some businesses to do tax planning in which they can channel away from that State legitimate income that has been earned within the State. In some cases these have been challenged in court and the courts are siding with the States. But there are issues that have not been fully litigated. And many tax planners for corporations are looking at those issues and saying," I really cannot put my company into that position to try to challenge a particular State law to determine if we have a significant presence within that State." The passage of H.R. 3220 would actually create a situation where tax planners would have an obligation on behalf of their corporation and their shareholders to minimize their tax obligations within the States. This will increase the burden of taxation on local business and local constituents because they are the only ones that will be remaining within a State that will be subject to the State's taxing jurisdiction.

Second, we truly believe that H.R. 3220 favors big over small. H.R. 3220 favors out-of-State businesses over in-State businesses and for our State that is not sound economic policy. I believe it is very important, and it is one of the reasons and one of the ideas that I truly believe in, that State tax policy should be fair and consistent for all taxpayers. H.R. 3220 goes a long way in separating that in creating winners and losers.

Third, I beg to differ, but H.R. 3220 is not clear and it is not simple. It does not create a physical presence standard. It creates something less than a physical presence standard. And I would argue that we will find in many States that audit activity and litigation will increase as auditors are looking into the activities of a business, would have to assess a tax and have the business come back and prove the activity that occurred was within one of the carve-outs which was established during this Federal legislation. I do not believe that is good tax policy.

Third, it is a step back in time for tax policy. At a time when our economy and our country, we are in a situation where we are now an electronic, borderless economy, most businesses have the ability to operate anywhere at any time without the encumbrance of a physical presence. However, H.R. 3220 tries to take the 19th century tax law on physical presence and impose it on a 21st century borderless economy. That does not make sense.

Finally, and most importantly, we believe that H.R. 3220 violates the principles of federalism. It violates over 225 years of federalism by taking decisions regarding economic development and job creation in our own States away from the Governors, the State legislators and mayors and puts it in the hands of Congress. For that reason, Mr. Chairman, and I look forward to answering questions specific to it, and for the reasons outlined in the statement I have provided in my opening comments, the National Governors' Association strongly urge the Subcommittee to reject H.R. 3220.

Congress should not implement legislation that will discriminate against local merchants and businesses cause States to incur severe revenue losses and set back over 225 years of principles of federalism.

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to speak with you, and again I welcome the opportunity to address specific questions.

[The prepared statement of Mr. Clayburgh follows:]

PREPARED STATEMENT OF RICK CLAYBURGH

Chairman Cannon and Members of the Subcommittee, I am Rick Clayburgh, Commissioner of the North Dakota Office of State Tax Commissioner. I am speaking to you today on behalf of the National Governors Association and thank you for the opportunity to address issues relating to HR 3220, the Business Activity Tax Simplification Act, and the impact it could have on all states.

NGA policy on the issue of business activity taxes is very clear:

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

The NGA opposes H.R. 3220 because it would unduly interfere with the ability of states to determine and manage their own tax policies. In the simplest of terms, HR 3220 would encourage—and in some cases, mandate—businesses to engage in tax shelter activities to avoid payment of state corporate income and other business activity taxes. It would impose new limits on the ability of states to tax entities engaging in business in the state, and prevent states from taxing income where it is earned. It would reduce every state's revenue base—with aggregate revenue losses likely reaching into the billions of dollars per year. It would unfairly shift the tax burden to local businesses and render most of these taxes virtually unworkable. Most importantly, H.R. 3220 runs directly counter to our system of federalism and places Congress in the position of making decisions that for over 225 years have been reserved to state and local elected officials.

Let me put the proposals in HR 3220 in context. When we talk about a state's jurisdiction to tax, also known as nexus, we are asking whether a company has sufficient activities in a state to allow that state to impose a tax on it. Business entities are legal fictions created on paper that have no physical being. These businesses are present in a state through representatives such as buildings, property, or inventory they own or persons they hire, such as employees and independent contractors, to do the company's work. They are present in the state through the activities they undertake such as leasing, contracting, licensing, selling, and the like. So, the key question is: When are the activities of a company that has no single physical embodiment, sufficient to bring it within the state's taxing jurisdiction?

Proponents of HR 3220 will tell you that the legislation establishes a straightforward "bright line" standard of "physical presence" for determining nexus, thus providing certainty for the business community. They will also argue that the measure will have little impact on state revenues. Nothing could be further from the truth. Let me briefly address some of the issues raised by HR 3220.

Point #1: Simple and Identifiable Standards

H.R. 3220 purports to establish a bright line physical presence standard for the imposition of state and local business activity taxes. In reality, the measure contains a series of conditions and carve-outs from the physical presence standard that would enable a corporation to engage in a substantial volume of activity in a state without being subject to the state's tax jurisdiction.

H.R. 3220 provides that an entity may be subjected to tax in a state if it has personnel or property in the state—

- Unless the personnel or property are in the state for fewer than 21 days or
- Unless the personnel or property are engaged solely in the solicitation of sales of tangible goods, intangibles or services or
- Unless the personnel or property are engaged in various activities such as news gathering, making purchases, or lobbying government officials, or
- Unless the activities of the entity are carried out by a contractor—a contractor that might be a wholly-owned subsidiary that may simply perform activities for two related parties.

In other words, there is nothing simple and nothing bright about the standard in H.R. 3220, and it certainly goes way beyond mere physical presence before a state would be authorized to levy its business activity tax. As an example, a company engaged in "gathering news" could have a permanent building in a state and permanent employees in the state and not be subject to tax. Likewise, a company that sold multiple products into a state could use an independent contractor to perform all its installation, servicing, and repair services in the state and not be subject to tax on its income.

In short, the so-called "bright line" standard that HR 3220 imposes is more a ruse than a reality—and represents a step backward in good tax policy.

Point #2: HR 3220 Legalizes—and even promotes—increased tax sheltering. By requiring that an entity have a physical presence in a state, H.R. 3220 would legalize the use of "intangible holding companies" and other related-party arrangements to shift income among states in a manner that avoids taxation. For the past several years, states have aggressively fought this form of tax sheltering. Many of those efforts would be for naught if H.R. 3220 is passed. In addition, H.R. 3220 would encourage and possibly require additional tax sheltering. Public companies—where corporate officers have a fiduciary duty to shareholders to boost their share prices and reduce their tax liabilities—would conceivably be required to take advantage of the same tax sheltering opportunities that to this point have been considered risky and aggressive. Thus, at the same time that Congress and the Administration are strongly advocating measures to curb the use of Bermuda-type tax shelters that affect the federal tax base, H.R. 3220 would encourage Congress to do an about-face and put its stamp of approval on legislation that would expand and legalize the use of tax shelters for state corporate income tax avoidance.

Point #3: Impact on State Revenue Bases. H.R. 3220 would have a significant impact on state revenue bases. While the fieldwork to estimate the impact of H.R. 3220 is still going on, the total impact will undoubtedly reach into the billions of dollars per year. In fact, one state has already estimated that the impact of the bill would amount to about a 20 percent reduction in its corporation income tax base.

Point #4: The Impact on Federalism. For 225 years, Congress has recognized the sovereign authority of states to raise revenue. This is a fundamental principle of federalism that is essential to the proper balance of the state/federal relationship. H.R. 3220 would decimate this core principle and supplant the authority and judgment of state and local elected officials with the judgment of Congress. It would make Congress and large corporations the arbiters of economic development decisions nationwide. Governors, state legislators, and mayors would no longer independently decide what business is good for the economy of their cities and states, what industry it wants to recruit to bring jobs to its citizens, or what type of business development incentives it wants to provide. Rather, enacting H.R. 3220 will establish a system where out-of-state businesses—businesses that compete for local customers and benefit from the services of state and local government that support the economy—will be exempt from contributing to the local schools, public safety, or transportation infrastructure while increasing the burden on in-state companies and local businesses. Congress should not damage the ability of state and local governments to use taxes to promote competition and fairness that are both constitutional and a major part of their fiscal systems.

For the reasons outlined in this statement, the National Governors' Association strongly urges the subcommittee to reject HR 3220. Congress should not implement legislation that will discriminate against local merchants and businesses, force states to incur severe revenue losses, and setback over 225 years of the principles of federalism.

Mr. Chairman and members of the Subcommittee, thank you for the opportunity to speak to you today. I welcome the opportunity to answer any questions you may have.

Mr. CANNON. Thank you, Mr. Clayburgh. I am certain that we will have questions for you.

Mr. Turner, you are recognized for 5 minutes.

STATEMENT OF VERNON T. TURNER, CORPORATE TAX DIRECTOR, SMITHFIELD FOODS, INC.

Mr. TURNER. Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify today. It is an honor to appear before you to discuss a matter of importance to Smithfield Foods and the business community in general.

My name a Tracy Turner and I am the Corporate Tax Director of Smithfield Foods. Smithfield Foods is the world's largest pork processor and hog producer headquartered in Smithfield, Virginia. We have worldwide sales of 9 billion and are a Fortune 200 company. Our company has experienced remarkable growth from its early origins as a small pork processor. Today we are a worldwide company with sales in all 50 States. Our various subsidiaries have physical operations in 20 States.

We incur substantial costs to meet our State tax obligations. On an annual basis we are required to file 860 State income tax returns, 450 sales and use tax returns, 3,150 State payroll tax returns and 215 real and personal property returns. This results in various State payment of almost $60 million. In spite of our efforts to comply with the laws of all the States, we continue to find State interpretations of the business activity tax to be difficult and troublesome.

The U.S. Supreme Court and Congress have decided that States may not unduly burden companies that have no physical presence in a State with business activity taxes. In 1992, the U.S. Supreme Court held in Quill Corporation vs. North Dakota that the U.S. Constitution requires a bright line physical presence rule for the imposition of use tax collection responsibility. Many scholars and State tax experts believe that the Quill standard applies to all State taxes, not just use tax.

Public Law 86–272, still good law, was enacted by the U.S. Congress to provide a similar bright line standard. It bars States from imposing a net income tax on companies whose only in-State activity is the solicitation of sales of tangible personal property. Despite the decision of the U.S. Supreme Court and Congress, States continue to attempt to tax companies regardless of physical presence. States have, for example, enacted and imposed gross receipt taxes, net worth taxes, and fixed dollar minimum taxes on out-of-State companies underthe theory that Public Law 86–272 bars imposition of only net income tax. States have argued, too, that Quill applies only to use tax. As a result businesses struggle with multi-state tax compliance in the face of confusing and conflicting guidance. This situation needs to be clarified and BATSA seeks to do that and nothing more.

Interstate sales are today more the rule than the exception, not only for large corporations like Smithfield but small and medium size enterprises as well. The current state of confusing and arbitrary taxation of multi-State companies that are selling product across State lines only serves to chill interstate commerce. BATSA will eliminate confusion and the need for companies to engage in protracted and costly litigation as a way of ameliorating discrepancies in tax enforcement.

BATSA does not diminish the ability of States to collect tax revenue. It rationalizes and makes more predictable the process of doing so.

We recently experienced a prime example of the arbitrary and confusing application of State income tax laws. This example is not a gross exception. In fact it is just a metaphor for a larger problem. A collection agent with the New Jersey Department of Taxation recently stopped one of our trucks loaded with refrigerated product on the New Jersey Turnpike. The agent held the truck and its driver for several hours and demanded that in order to release the truck Smithfield had to wire $150,000 immediately to the New Jersey Department of Taxation. The agent claimed that he had the right to hold the truck and its contents because we had failed to properly file New Jersey tax returns.

I informed the New Jersey agent that his claim was unfounded. I explained that Public Law 86–272 protected our subsidiary from New Jersey taxation since it only engaged in mere solicitation in New Jersey and had no physical operations in the State. The agent refused to accept this explanation. However, he finally agreed to release the truck and its driver in return for $8,000. We appealed this aggressive and incorrect application of Public Law 86–272 to the New Jersey State Tax Commissioner. Ultimately, New Jersey accepted our contention that we have no physical presence in the State and are not subject to New Jersey income tax. They issued a refund and an apology for their roadside justice system.

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

Thank you very much.

[The prepared statement of Mr. Turner follows:]

PREPARED STATEMENT OF VERNON T. TURNER

Thank you for inviting me to testify today. It's an honor to appear before you to discuss a matter of importance to Smithfield Foods, Inc. and to the business community in general. My name is Tracy Turner, and I am Corporate Tax Director of Smithfield Foods, Inc.

I. INTRODUCTION

- *Background on Smithfield Foods, Inc.*

Smithfield Foods, Inc. is the world's largest pork processor and hog producer, headquartered in Smithfield, Virginia. We have worldwide sales of $9 billion, and are a "Fortune 200" company. Our company has experienced remarkable growth from its early origins as a small pork processor. Today, we are a worldwide company, with sales in all fifty states. Our various subsidiaries have physical operations in twenty states.

- *Why Smithfield is testifying*

We incur substantial costs to meet our state tax obligations. On an annual basis, we are required to file 860 state income tax returns, 450 sales and use tax returns, 3,150 state payroll tax returns and 215 real and personal property tax returns. This results in various state payments of approximately $60 million. In spite of our efforts to comply with laws with all the states, we continue to find state interpretation of the business activity tax to be difficult and troublesome.

II. THE PROBLEM—BUREAUCRATIC ARBITRARINESS

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

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

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

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

III. BATSA

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

IV. A RECENT SMITHFIELD EXPERIENCE

We recently experienced a prime example of the arbitrary and confusing application of state income tax laws. This example is not a gross exception. In fact, it is just a metaphor of a larger problem. A collection agent with the New Jersey Department of Taxation recently stopped one of our trucks, loaded with refrigerated product, on the New Jersey turnpike. The agent held the truck and its driver for several hours, and demanded that, in order to release the truck, Smithfield had to wire $150,000 immediately to the New Jersey Department of Taxation. The agent claimed that he had the right to hold the truck and its contents because we had failed to properly file New Jersey tax returns.

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

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

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

Mr. CANNON. Thank you, Mr. Turner. Commissioner, I know you are here representing the National Governors' Association but you are also the Treasurer of the MTC. Would you mind if I asked a couple questions about the MTC and you may or may not speak on behalf of them but perhaps could you give us some guidance on their thinking.

Mr. CLAYBURGH. I certainly will.

Mr. CANNON. I was surprised by the directness of Mr. Rosen's statement that the MTC citing the FTB, Franchise Tax Board of California, I think the term "false" was used directly.

I have been handed actually a copy of a press release that apparently came from the MTC. The Multistate Tax Commission warned today that H.R. 3220 would legalize the controversial tax shelter schemes. The bill would allow income shifting gains made notorious by a handful of companies in order to avoid paying tax to State governments which are still shaky in the wake of a recent economic recession.

That is a pretty intensely political statement by an organization that would be thought to be more analytical, and I would like you to comment on that if you will, but at the same time,as I mentioned earlier, we have a series of issues here that relate how States can tax. We have the Internet Tax Freedom Act, we have the Streamlined Sales Tax Proposal, which I believe Mr. Delahunt is going to talk about. These are not partisan issues. These are, however, thoughtful about taxing ourselves.

As you know, the Multistate Tax Commission came out with a study that is a little bit outrageous, but even if you say it is not intended to be so political, it suggested that the States would lose somewhere between $4 and $9 billion a year, couched in today's terms, as opposed to the time frame it would take for the Internet Tax Freedom Act to have some effect, and that had a fairly profound effect on the legislative process, especially on the other side of the building.

I would actually like to deal with the issue of how political the MTC is and why, as opposed to dealing with them here, because we have had a very pleasant discussion, rationally, and your presentation was very compelling, but what are State tax commissioners thinking in the long term?

In other words, I just have to say as an aside that the Tax Commissioner of Utah is a guy named Bruce Johnson, whom you may know. Bruce has been a friend of mine for a very long time, but I just absolutely hate Bruce.

For the record, this is a joke, although this is not really a joke. The reason is my wife dated him, so he is the perfect human being to whom I am always compared and has been for the last 28 years. But we recently had a very intense conversation on this subject. Why is the State of Utah not looking beyond the issue of the ITFA and they are relatively significant taxes they have there, when you have, I am not sure what the number is, but Business Week 3 or 4 weeks ago said that the SSTP said lost revenues on the Internet—I am not sure if that means catalogs and other things—are $35 billion. Why are we tripping over $35 billion over what even in an exaggerated sense is $4 to $9 billion based upon taxing the Internet?

I am going to give you some time to answer that, but let me add that it seems to me in a rational system you would want the goose that produces the golden eggs to be well fed and comfortable, maybe a little bit of exercise, but you do not want to interfere with the golden eggs. And information is the context for virtually everything that we are doing in America and in the world to create an economically vibrant system. So why on Earth would we want a balkanized system of State taxes on our information process? And is anybody at the MTC thinking rationally and long term about this?

I am sorry. The rational does go back to the politicized statement here. But are we thinking about that and is there some way to move the MTC to a position of saying, look, the SSTP is important, the BAT is really important, and the ITFA is not very important?

Mr. CLAYBURGH. Thank you, Mr. Chairman. I will start to answer the question. If I am not getting all your points, please stop and clarify for me and I will try to address those.

First of all, I am here on behalf of the National Governors' Association. I am the Treasurer of the Multistate Tax Commission, as you have stated. I am also on the Board of Trustees of the Federation of Tax Administrators. Very briefly, I want to give a background of myself. I am a Republican. I am elected in the State of North Dakota. I am formerly involved in a business.

Mr. CANNON. That makes you dramatically different from Bruce, who actually gets appointed. We love your State's approach.

Mr. CLAYBURGH. But I have to disagree in some respects. The goal of the Multistate Tax Commission and the reason that a number of States participate in it, and one of the issues that I enumerated in my opening remarks, is something I believe so strongly in and that is fairness and consistency within tax administration.

The Multistate Tax Commission's real role is trying to deal with uniformity, consistency and certainty amongst taxes for businesses that are doing business in multiple states. The Commission does just an outstanding job there. I do not have any disagreement on how the Multistate Tax Commission deals with that.

The issue and the discussion in the release has to deal with one of the aspects and the concerns that have been enumerated publicly across this country, "what will occur with the issue of tax planning?"

Now you and I both know that 99.99 percent of all corporations are outstanding members of our communities, are outstanding members of this country. They provide jobs. They provide opportunity. They provide economic growth. They are good for our society. They are good for our State, but they still have an issue that impacts those, and that is that legal side or that tax planning that may occur with an area that we do not have tax law that is specific yet in States, and they are challenging to try to determine what is the law in a State.

Mr. CLAYBURGH. For example, in the K-Mart case in New Mexico or Jeffries in North Carolina, that issue of the Multistate Tax Commission is an issue of trying to provide uniformity and consistency.

I have to tell you, from the standpoint of business activity taxes, in my role as tax commissioner in North Dakota, we work with the business community in our State, both in State and those from a multi-State jurisdiction that do work within our State. Most recently, we sat down with tax preparers and members of our audit staff to go over an issue that we had some disagreement with and gave the tax preparer an opportunity to hear what was the issue the tax department was looking at. And it gave the tax department an opportunity to understand where the taxpayer was coming from.

By the time the day was done, it was about a 2-hour meeting, we had the issue resolved. And it is not an issue anymore. I have been tax commissioner for 8 years in North Dakota and have been on the board of the FTA and have been on the board of the MTC. I have talked with our Governor, and I have a great relationship, as a former legislator, with our legislative leaders in North Dakota. We are not aware of, and people have not been bringing to us significant problems, with business activity taxes.

I am proud of North Dakota and what we have done in the tax department. We have been able to reduce the size of our agency. And we have been able to focus on customer service and make sure people are treated fairly, efficiently and effectively. We have turned nearly $4.5 million back in unspent revenue authority.

I am just giving you a background of where I am coming from. The purpose of all of this is, we have a problem with business activity taxes. I think it is important for the business community to sit down with the governors and say, "Here are our issues." States are willing and able to sit down and listen. We have shown it, both with streamlining and shown it with the sourcing rules with wireless. If we are presented the problem, we can sit down and work the issues out in a way that is fair and reasonable to all taxpayers, to all businesses and to the States.

But really, we haven't been given that opportunity here. This has been an issue that really has surfaced here in Congress but is not surfacing, for the most part. Now there are specific issues that will pop up occasionally, and yes, there are egregious issues that will come out from a State. All I am trying to say is, let us sit down and let the States sit down with the business community to try to resolve this before we take a one-size-fits-all piece of Federal legislation and put it in all States, because what is good for South Carolina may not be good for North Carolina, and what is good for Utah may not be good for North Dakota.

Mr. CANNON. I think an elected tax commissioner would be wonderful for Utah. And I am going to suggest that to my State legislators.

I did not mean this to be a personal attack, and I hope you will do me a favor in your next meeting with your Multistate Tax board, I hope they will take a look, first of all, the politicization that happened on this bill and the politicization that happened on the Internet tax as it went over to the Senate and consider, long-term, where you want to go with this, because I think there were serious concerns with that Internet Tax Freedom Act Report that went to the credibility of the MTC, and that, I think, is unfortunate.

I hope you will go back and consider with those folks where States ought to be going and what they ought to be thinking, because I would like to see the Internet Tax Freedom Act pass the way we passed it here.

With that, let me yield 5 minutes to the gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

I am trying to get a handle on this, so let me ask a couple of basic questions.

Mr. Rosen—any one of you could answer these questions but since you testified first—I assume there are States that have no income taxes, is that correct?

Mr. ROSEN. There are a few.

Mr. WATT. What are those States?

Mr. ROSEN. States that have taxes instead of income taxes, a number of States, depending on the industry. Some impose gross receipts tax. Others have alternate bases based on capital. And the State of Nevada has no corporate level tax at all. That is the only State with no corporate level tax at all.

But there are variations on income taxes. And that is the concern on one of the changes what is being done to 86–272. The State of New Jersey passed a law that says, if you are a corporation and you are protected by what Congress has passed, you've got to pay another tax. And only those companies have to pay a tax based on gross receipts. Otherwise, what it is trying to do is trying to beat what Congress has tried to enforce.

Mr. WATT. The question I am trying to get to is, is it theoretically possible that, with a physical presence test, you could conceive that a number of businesses would flock to a State that has no income tax if that is the sole criteria? What is the likelihood of that?

Mr. ROSEN. I would think it is almost nil for the following reasons. As we all recognize, the physical presence test has been the practical, if not the legal, standard that has been in effect in this country forever.

Mr. WATT. You keep saying that, but we are here because, apparently, that is not working.

Mr. ROSEN. The States are trying to change it because they are trying to tax outside their borders. And so it has been that way. So if it were true, every corporation in this country would be located in Nevada.

But that is not true, because actual businesses and operations cannot be dependent totally on tax policy. For example, a number of businesses have to have warehouses and factories where people are located whether they be employees or markets. So that is shown not to be true. We have an example where Nevada has not attracted all the businesses in the country.

Mr. WATT. Okay. Is that possibility increased by the level of technology that we have today as compared to what we had 20 years ago?

Mr. ROSEN. It might be, and that seems to be part of what sovereignty is all about, that States will have tax competition. And if a State wants to attract a certain type of business, it can do that.

And the fact that you have an electronic business located in State A with customers in State B, we don't understand—those of us who support BATSA—why State B, where merely customers reside, should get any tax revenue because they are not providing—that State is not providing benefits and protections to the labor and capital that company A is putting in to making the profit.

And generally, jurisdictions that do give protection and benefits, the economic inputs that generate income are those that should be able to collect the tax just as the United States does with its foreign treaty partners.

Mr. WATT. Let me ask Commissioner Clayburgh and ask him to give me the other side of the answer, if you have a different perspective.

Mr. CLAYBURGH. Thank you, Mr. Chairman, Mr. Watt.

The situation occurs now that if a business—because many States have legislation in place—in North Dakota, we are a combined reporting State. It allows the State to be able to bring into the whole picture the business activity of the enterprise that earns income attributable to the State of North Dakota. It is determined—what goes into the formula to determine what fairly should be taxed and paid to the State of North Dakota.

Mr. WATT. And what kinds of things are you taking into account other than physical presence?

Mr. CLAYBURGH. In the case I am referring to, if we have an entity or a subsidiary that provides services and helps to address an activity of a company that is doing business in North Dakota, that can be pulled into the process. And so if you have a situation where income may be shifted into a non-income-tax State for the purpose of trying to create nowhere income, we have the ability through combined reporting to bring that back.

The issue we have, though, is with H.R. 3220. It doesn't matter if you have those rules. We will lose that aspect within the numerator, and we will see a reduction in an existing tax base.

Mr. WATT. I am a little confused about what things other than physical presence would trigger your belief that your State should have the right to tax.

Mr. CLAYBURGH. Again, Mr. Watt and Mr. Chairman, the focus is not physical presence, because that is not the standard for business activity tax. It looks at a number of things. And as I brought out in my opening statement, a corporation is a——

Mr. WATT. I am trying to figure out what those things are. Are they enumerated in your testimony?

Mr. CLAYBURGH. Mr. Watt, I can follow up. I am not certain if I am following your question specifically. We look at——

Mr. WATT. You say, you look at a number of things other than physical presence.

Mr. CLAYBURGH. We are looking——

Mr. WATT. I am trying to figure out what those number of things are that you look at other than physical presence.

Mr. CLAYBURGH. We will look at economic presence activities; items that occur through the corporate structuring in which the corporation has some type of economic presence in our State in which they are gaining benefit of the laws of the State of North Dakota.

Mr. WATT. Give me an example.

Mr. CLAYBURGH. For example, you may have a company that is totally housed outside the State of North Dakota that has no physical presence. But they provide support, and they come in and will be providing activities into the State in which they hope the State of North Dakota has a good road system, that we have a good police system, a police force in place, that we have a court system in place to be able to enforce their contracts under our commerce activities. They are also assuming—and this is probably one of the things that is lost in all of this.

That we have an education system in North Dakota that not only ensures a well-educated workforce but also a well-educated population. And with higher education and expanded education, people do better in jobs and get more income. And that brings more revenue and more dollars into the stream of commerce in this country, allowing them to purchase more. So that benefits companies across this country. And to say otherwise is ridiculous.

Mr. WATT. I hear what you are saying. I am just trying to figure out what the articulable standard would be. I understand that if there is a brick and mortar, there is a physical presence. If there are employees, I presume that is a physical presence. How would you articulate the standard that you are using?

Mr. CLAYBURGH. What I have tried to do today and what I am trying to do is keep all of my discussions more at the policy level.

Mr. WATT. I am beyond my time anyway.

Mr. CLAYBURGH. If I could, I will follow up with a written statement.

[The information referred to follows in the Appendix]

Mr. CANNON. The chair would appreciate that, and do it within the next 5 days. That will work for our time frame.

Mr. WATT. I have no further questions.

Mr. CANNON. Consistent with our earlier unanimous consent or agreement, Mr. Goodlatte, would you like to ask questions?

Mr. GOODLATTE. Mr. Chairman, I thank you for the opportunity.

I first would like to ask unanimous consent for inclusion in the record a very long list of examples of actual and potential aggressive State actions and positions against out-of-State companies that are very much along the lines of that described by the representative of Smithfield——

Mr. CANNON. Without objection, so ordered.

[The information referred to follows in the Appendix]

Mr. GOODLATTE. That makes this clear. This is not an isolated or rare occasion.

And in response to the testimony of the commissioner from North Dakota, I have to tell you, when you say this would encourage and expand tax planning, I think just the opposite. And I am going to ask the other Members of the panel to respond. I think just the opposite will occur.

The current morass of laws and the competition and aggressiveness between the States to reach further and further into some of the most obscure reasons why they think contact with a State—we have had States discuss the fact that your logo appears in the State should be sufficient to require business activity. So that would be every business in every State. The fact that you drive as few as 6 trucks through a State, not stopping, just driving through the State would be sufficient contact. The fact that you have a server that serves your Web site located in the State would be sufficient contact. The fact that you send a business delegation to participate in a conference and have a booth, not even conduct any sales transactions, just be present at a convention for 1 weekend, should be sufficient contact in the State.

This causes businesses to have to expend enormous resources in terms of tax planning and enormous further resources to dance on the head of a pin to comply with these multitude of different morasses. And finally, I think it is a very strong argument that States waste enormous amounts of resources trying to pick up very small amounts of additional revenue by these de minimus contacts that businesses have with States. I would like to ask Mr. Rosen and others if they would like to respond to the contention that this would encourage and expand tax planning.

Mr. ROSEN. I think it might be important to start with the understanding of the motive here of those who are supporting BATSA. And the motive is not to reduce taxes. It is to maintain the status quo. The concept of economic nexus is something new that the revenue departments are trying to assert.

Congressman Delahunt asked the question about court cases. There have been a number of court cases and State court cases, and in every single one of them, the court has established that physical presence is a requirement for direct tax outside the tax shelter area. In normal business operations, every court, there have been five or six decisions, unanimous, held that there must be physical presence. We are trying to maintain the status quo.

As far as tax planning goes, as we said earlier, every State has mechanisms at their disposal to fight any structures or transactions they believe inappropriate. They have the common law arguments, such as business purpose, economic substance. Mr. Clayburgh's own State has combined reporting and throwback. And when you do that, there is really no opportunity for tax planning. Those who do that for a living are going to be in big trouble.

What this bill would do is have uniformity around the country. Mr. Clayburgh talked about one-size-fits-all; that is not a good idea. You have to have uniformity, and we think doing things differently State-by-State is dangerous.

Mr. GOODLATTE. I want to get Mr. Van Fossen, as a State legislator, to respond to the assertion that this bill runs counter to the system of federalism.

Again, in my opinion, that—when you talk about the inter-relationship of States, we are not just talking about what one State can do, we are talking about what impact that one State might have on all the other States. So if you might comment on that Mr. Van Fossen?

Mr. VAN FOSSEN. Thank you, Congressman.

That is the tack I take. I reject economic nexus. I am looking at it from an Iowa business standpoint. And the fact that Representative Watt asked the genesis of the 1959 law, which was an Iowa company—it was Northwest Portland Cement, which was doing business in Minnesota. And Minnesota tried to tax that company and that led to Congress passing Public Law 86–272. I am looking at it from the standpoint of Iowa businesses doing business in another State and those businesses being taxed at a higher rate, in this instance, in Minnesota.

So I think that, as you mentioned, that this does set up uniformity across the country, across the States, that allows businesses—not only large businesses but small businesses—to interact with uniformity.

Mr. GOODLATTE. Let me interrupt, as a guest of the Subcommittee, and my time has expired as well, I just want to make a couple of very quick points.

In response to the very clear list that the gentleman from North Dakota has given us, favors big over small, I don't think anything could be further from the truth. EBay alone has 450,000 businesses where people make their primary income on the Internet on eBay. Millions of other people obviously sell things. Many of those are corporations that could be entangled in this. Many, many small businesses sell in a multitude of places. They have a place where they are based and located. They can be taxed there very cleanly, very plainly and very simply. And when they have to comply—and this is not the sales tax issue, I want to make it clear.

This bill exempts sales tax from the consideration of this bill. You are talking about all other kinds of activities that States try to claim a contact with, these small businesses. I think it has exactly the opposite. Big business has more resources to handle this morass that they currently confront than small businesses do.

And finally, not clear and not simple, my goodness, I think you might have some problems with some clarity. We are willing to talk to anybody who wants to clarify any point in this bill. But compared to the current situation that any business faces, you can't make the argument that this is not clear and not simple compared to where we are going right now and where we are heading if we do not do something like this legislation.

And step back in time? Tax policy, no. This is current tax policy and having a clear definition based upon physical presence—and we can debate what the parameters of that are—I think is the soundness that every State needs when their sovereignty is being tested by the nature of the Internet more than anything else in history because of the ease with which things go across State lines. Having that bright-line test based upon physical presence, I think, is a necessary part of States being able to continue to argue that they have a reason for existence when the Internet is becoming as prevalent as it is.

Mr. CANNON. I thank the gentleman.

Let me just point out, I felt that Mr. Turner's testimony went to the point you were just making about the complexity that his company faces is remarkable. And it creates difficulty for any business. But the State police authority to stop a truck because of some disagreement on something of thousands and thousands of returns is actually quite scary.

Mr. Delahunt, would you like to take 5 minutes?

The gentleman is recognized.

Mr. DELAHUNT. You know, I think we have heard these arguments in different times with different proposals. You know—and I agree with my colleague from Virginia and many who serve on this Committee, we are at a different time.

What we see, of course, is a growing percentage of commercial activity in this country being dealt with in terms of e-commerce. I mean, the numbers are staggering. That is the reality.

And yet we hear this old test of physical presence and a bright line being utilized. There seems to be a certain incongruity there. I mean, I was just reflecting for a moment on—I think it is

Citibank, the credit card. They are incorporated in South Dakota because there are no limits in terms of interest rates. There are no caps. Yet in Massachusetts, I dare say that the economic gain and benefit for Citibank credit card profits or revenue sources, it far exceeds what the activity is out in South Dakota. I mean, South Dakota just simply has, you know, a small population.

So maybe we have to think about new definitions, other than physical presence. But I think we ought to get really realistic here, and I know that these issues aren't going to go away. But I said earlier that I support the permanent moratorium of the so-called Internet Freedom Act.

I also think it is absolutely essential that we do something about the collection of sales-use tax. Now there are some people on this Committee that are opposed to that. But I can tell you something, I don't see this bill going anywhere. Maybe it goes through the House, but it isn't going to go through the Senate. You can count on that.

We have already known what has happened to the moratorium legislation. It has been held up in the Senate by Republican senators, by the way, some of whom formerly served as governors.

So I think that Commissioner Clayburgh, maybe it is time as you suggest, for the business community, for States and for the small business community, you know, to sit down and talk these issues out, because nothing is going to happen, I can tell you now, until there is some sort of resolution. We can sit here and talk about, you know, whether our understanding of the concept of federalism—and it makes for a great, interesting academic conversation, but that is the extent of it.

Mr. CANNON. Would the gentleman yield?

Mr. DELAHUNT. Sure.

Mr. CANNON. This is an odd combination of State versus Federal, State against State and Democrat and Republican because it is not versus so much here.

The gentleman from Massachusetts and I agree entirely on the fact that we have an irrational system, and it is a system that has come to a total stop. In other words, no Internet Tax Freedom Act, no SSTP. And we are going nowhere with the business activity tax.

So somewhere along the line, people who have a problem, that is the States—I mean this is—the States do have a problem. And I might point out that the Multistate Tax Commission is an interstate compact in the subject of the jurisdiction of this Committee. But we are going nowhere, and that is not good for anybody.

We are going to have a lot of different views on each of those subjects. But the reason I think that the gentleman from Massachusetts is talking about the ITFA is because we have a combination of things where people are just saying, "We are going to hold out" and as long as that happens, the American people are going to say, "Wait a minute, if the House bill passes, my phone bill is going to fall by half," because half of most peoples' phone bill is currently taxed, half to a third.

So I don't think the American people are going to stand around for this very long. And you need to be thinking of what we can do to create a rational system that rationally taxes, that doesn't distort business decisions and certainly doesn't impede the foundation for the next phase of our economic development, which is the Internet.

And I apologize, and I won't watch the red on the clock until the gentleman is finished.

Mr. WATT. Would the gentleman yield for my tirade?

Mr. DELAHUNT. Of course.

Mr. WATT. I am not going to do a tirade, but that is one reason I was suggesting that, if the physical presence standard is not the standard, then we need some articulable standard if this is going to get off the dime. And I don't know what that standard is.

I confess. I didn't understand it from Mr. Clayburgh. I understood that States have an interest in collecting taxes and that there are things other than physical presence that triggers that interest. But I am having a little trouble articulating what that standard would be.

And if we are going to clarify this at the Federal level by writing a piece of legislation, seems to me that it is not just what we are against passing all the time, given the log jam we are in, but somebody needs to be thinking about what the articulable standard is and should be to get off this dead log situation. I yield back.

Mr. DELAHUNT. I think, in addition to the States and clearly we—I think everyone on this panel respects the sovereignty of the States and the need for them to be able to make decisions.

At the same time, I think there is a certain reality out there in terms of the business community. There will be winners and losers, not—you know, the world hasn't simply come down to eBay. We are not just at that stage, in terms of our commerce, where it is all electronic. And I think we make a mistake in terms of the social implications if we ignore the fact that there is a reality of brick-and-mortar stores, particularly the small business within a community, because I can trust you can take this to the bank, Mr. Rosen, it is that small independent business store that operates, you know, in a small downtown that is going to sponsor the Little League. It is not going to be some seller on eBay, or it is not going to be eBay.

So there are a whole array of values that go into this decision. And whether it is the Internet Tax Freedom Act or SSTP or this, I can tell you now, all right, you will be back here next year, the year after, because there are passions on all sides of the issue. There are some that just want to say, pedal to the metal, what we are going to do is we are going to simplify everything. I think that is one value that is a positive value in terms of simplification.

But there are a whole mix of values that I think have to be looked at. And you know, maybe, Mr. Chairman, we ask representatives of the various stakeholders to come and do staff briefings and see whether there is a way out of this morass, because you have to start talking together, because my own personal assessment is that the political will here in Congress does not exist.

You know, this bill, filed by my friend from Virginia and my other colleague who sits on this Committee, Mr. Boucher, you know, maybe it will go to the House, but it ain't going to happen, with all due respect to my friend from Virginia.

Mr. CANNON. By the way, we can only control the House. We can do it. But as the gentleman suggested it takes two bodies.

And the gentleman and I have talked on many occasions about this issue. It is a bipartisan concern. America needs to solve this problem.

Mr. Rosen, we need to have businesses have clarity in planning.

We appreciate the comments of all the members of the panel.

And at this point, the hearing will be adjourned.

[Whereupon, at 3:30 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

McDermott
Will&Emery

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June 11, 2004

VIA ELECTRONIC MAIL

Diane K. Taylor, Counsel
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
House of Representatives
B353 Rayburn House Office Building
Washington, DC 20515-6216

Re: Follow-up Questions to 5/13/04 Hearing on H.R. 3220

Dear Ms. Taylor:

I am responding to Chairman Cannon's letter dated May 21, 2004, in which he requested my response to several additional questions; those questions and my responses thereto follow. This letter also provides a response to the questions posed by Congressman Coble that accompanied Chairman Cannon's letter.

Questions Posed by Chairman Cannon

1. *Is the physical presence standard outdated? Why or why not?*

No. The physical presence standard is not outdated because income – even in today's economy where technology, intellectual property, and services dominate – is still generated by human labor and capital. While intellectual property is certainly an important generator of income, that occurs only when such property is put to use by human beings, either directly (as is the case with listening to music) or indirectly through tangible property (as is the case with employing software on a computer). Although services can be provided to a customer in a location without the seller being physically present there, the income produced is still derived from the application of human labor or the productive use of physical assets (whether employing intellectual property or not) at some location somewhere. Even in the context of those businesses that focus on intellectual or other intangible property, income is actually generated by the people or equipment developing and/or using that property. A financial institution, for example, generates interest income through its finance, marketing, and other operational personnel using sophisticated computers and other equipment.

Taxes support governments so that governments can provide services for the benefit of its citizens. Governments provide services in the form of law enforcement, public health, education, and the court system – services that benefit human beings and physical property.

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Human beings and physical property (whether using intellectual property or not) are still the fundamental elements of our society and thus remain the appropriate prerequisites for taxation of business activity.

2. *Should the concepts addressed in H.R. 3220 be developed through a process similar to the Streamlined Sales Tax Project? Why or why not?*

No. H.R. 3220 presents a pure policy issue while the Streamlined Sales Tax Project is attempting to address an administrative/technical area. The SSTP is an effort to simplify and harmonize the very complex, detailed sales and use tax systems in over forty states to make such systems simpler to administer. The project, which has been in operation for many years and will need to continue indefinitely, grapples with issues as granular as when "food" becomes "candy" (when it contains no flour), whether hypodermic needles are "medical equipment," how often a locality may change its tax rate, etc. On the other hand, the issue addressed by HR 3220 is "black and white." That issue, *i.e.*, when an interstate business may be subject to a state or locality's business activity tax, does not attempt to address the types of tax(es) that states and localities may impose, the components of each such tax, allowable rates, etc.

More to the point, there is a fundamental disagreement concerning what the nexus standard for business activity taxes should be in today's economy. This is in stark contrast to the situation that gave rise to the SSTP. First, the overall issue of when the states could require interstate businesses to collect sales and use taxes has already been settled (by U.S. Supreme Court decisions in *National Bellas Hess* and *Quill*). Second, while the granular issues of the SSTP have been the subject of much controversy, the underlying goal of the simplification of the sales and use tax laws was shared (perhaps for different reasons) by both the business community and the states.

Moreover, certain revenue department organizations (such as the Multistate Tax Commission) have publicly stated that they would never consider compromising on the issue of a physical presence nexus standard. A group of state tax administrators and industry representatives, after holding a number of meetings, also agreed that a compromise on this issue would never be possible. In light of such statements, it is clear that there is simply no middle ground or room for compromise on the business activity tax nexus issue in a cooperative forum similar to the SSTP.

Accordingly, establishing a bright-line state tax nexus standard for interstate commerce is an appropriate task for Congress to undertake – a task that would simply set a national policy, not one requiring coordination of vastly different taxing schemes.

3. *How will H.R. 3220 reduce controversy over the appropriate nexus standard?*

H.R. 3220 provides simple and identifiable standards that will significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government. It is unlikely that H.R. 3220 will end all controversies, and no statute can ever do that; opponents of virtually any proposed legislation consistently present strained interpretations of bill language in attempts to defeat the legislation. However, any statute that adds clarification obviously reduces the amount of controversy and litigation by "narrowing" the areas of dispute. For example, in the 45 years since its enactment in 1959, Public Law 86-272 has generated relatively few cases, perhaps a few score throughout the country. On the other hand, areas outside its coverage have been litigated extensively and at great expense. Recent litigation has focused on what the appropriate nexus standard for business activity taxes actually is; there is no indication that this issue will be settled absent Congressional action.

4. *Please respond to the arguments made by the National League of Cities and the Multistate Tax Commission that H.R. 3220 will result in state-tax-revenue loss. In your opinion, are these claims accurate and responsible?*

There simply is no basis for any contention that H.R. 3220 could lead to any significant loss of state tax revenues. These arguments appear to be a scare tactic as opposed to arguments with merit. H.R. 3220 does not depart to any significant degree from what is now being done in the states. H.R. 3220 would have no effect on taxes derived from businesses that maintain a facility in the jurisdiction for more than 21 days during the taxable year. Clearly, state and local governments derive most – if not virtually all – of their business activity tax revenue from such businesses. The amount of revenue received by taxing jurisdictions from those businesses that maintain no office, store, warehouse, or other facility – or even inventory – (i.e., with no physical presence) in the jurisdiction at all must truly be minimal.

The National League of Cities has stated that H.R. 3220 would lead to state and local governments losing a "substantial portion of the more than $60 billion in annual business activities." Such a claim is meaningless in the absence of reliable data and analysis of the revenues that are currently being received by state and local governments and that would be placed at risk by H.R. 3220. Projections of revenue loss have also been undermined by recent statements of revenue impact made by certain state revenue departments and their representatives that have proven to be highly unreliable because the "estimates" focus on potential effects from hypothetical restructurings by businesses, are based on hypothetical changes in state law, or cite to potential impacts on apportionment rules (which is an issue of how much to tax, not whether to tax).[1] Such considerations do not make for a reliable or accurate revenue estimate; proper revenue estimates are based on projected changes to revenues currently collected.[2]

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[1] *See, e.g.*, the debunking of the report of the California Franchise Tax Board concerning H.R. 3220. *Response to California Franchise Tax Board Analysis of H.R. 3220: The Federal Business Activity Tax Bill* (provided by the Coalition for Fair and Rational Taxation), 32 State Tax Notes 9, at 697 (May 31, 2004); *See also* Arthur R. Rosen and Karen S. Dean, *Is the Sky* Really *Falling?*, 31 State Tax Notes 381 (Jan. 28, 2004).

[2] Moreover, revenue estimates have been made based on faulty or baseless interpretations of current law and/or H.R. 3220. For example, the New York City Department of Finance has submitted an estimated revenue impact that appears to disregard the common approach to combined reporting employed by jurisdictions throughout the country, including New York City, that treats taxpayer and nontaxpayers alike. The letter is devoid of any explanation of how the figure was determined. *See* Testimony of Martha E. Stark, Commissioner, New York City Department of Finance In Opposition to H.R. 3220, The Business Activity Tax Simplification Act before the Committee on the Judiciary Subcommittee on Administrative and Commercial Law (May 13, 2004).

Consider first states that impose a net income tax to which Public Law 86-272 applies. It is difficult for tax practitioners, corporate tax managers, and several government officials that were queried to believe that these states are actually collecting any material amount of revenue from businesses that have no office, other facility, or inventory in the state and have non-solicitation employees in the state for zero to 21 days during the year. This is particularly true considering that any income from the solicitation of services would not generally be sourced to the state where the solicitation takes place because almost all states use a "place of performance" test for sourcing services. Thus, there simply cannot be many businesses paying such taxes and any revenue loss would be negligible.

Consider next those states, such as Michigan, New Jersey, Texas, and Washington, that impose business activity taxes that are not solely based on net income and, thus, are subject to the protections of Public Law 86-272. These states are currently able to collect revenue from out-of-state businesses that do not themselves maintain an office or other facility in the state but that employ individuals in the state who perform solicitation in that state. Modernizing Public Law 86-272 to cover non-income taxes clearly means that such states will no longer be able to collect this revenue. The amount of tax paid by such businesses, however, again must be minimal because it is highly unlikely that businesses are paying business activity tax to states in which they only have a fleeting presence.

It is essential to keep in mind that H.R. 3220 is based on the principle that a business engaged in interstate commerce should pay its fair share of tax. H.R. 3220 does not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the correct jurisdiction. Claims of revenue loss by critics of H.R. 3220 merely masks their real reason for opposing the legislation, namely that state revenue departments and their representatives do not want any legislative constraints on or oversight of their taxing authority – even when the legislative constraints are squarely within Congress' authority to regulate interstate commerce.

5. *Please respond to Commissioner Clayburgh's remarks that H.R. 3220 encourages and expands "tax planning." What is the difference between "tax planning" and "tax sheltering"?*

Critics have charged that H.R. 3220 would encourage "tax planning." Raising this objection is a classic "red herring" attempt to gain emotional mileage out of a politically-charged topic. First, such claims do not distinguish between abusive tax sheltering and legitimate tax planning; there is a significant difference between the two. As Judge Learned Hand reminded us in *Gregory v. Helvering* some 70 years ago, taxpayers have a right to interpret ambiguous laws in a reasonable way so as to lower their taxes.[3] Legitimate tax planning consists of minimizing tax burdens by entering into actual transactions or actual restructurings. For example, an individual who decides to purchase a home instead of renting and takes advantage of the mortgage interest deduction is engaging in tax planning. On the other hand, a company that establishes a "paper

[3] *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) ("anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.").

subsidiary" with no employees or property solely to reduce taxes would be engaging in inappropriate, or abusive, tax sheltering.

In that context, H.R. 3220 neither encourages the use of abusive tax planning nor nullifies the ability of states to attack such shelters. Under H.R. 3220's physical presence standard, businesses are taxable in a jurisdiction if that business maintains property, including inventory, an office, or other facility, or non-solicitation employees. As a result, to engage in "tax sheltering," a business would have to engage in a physical relocation of its actual business operations to avoid taxes, not just a paper restructuring, and there is no evidence that businesses engage in unworkable restructurings simply to avoid paying state taxes. In fact, the Congressional Willis Commission studied the impact of the enactment of Public Law 86-272 and concluded that virtually no companies had changed their business methods or structure in order to come within the protections of that statute.[4] At any rate, if any business were to relocate, it would be required to pay taxes to the jurisdiction to which it moved.

Moreover, H.R. 3220 would have **no** effect on the ability of states to attack tax shelters using weapons such as combined reporting (which states comprising a large majority of the American economy can currently employ), I.R.C. § 482-type authority to made adjustments to properly reflect income, statutory addbacks, or similar provisions, and the common law principles of economic substance, alter ego, and non-tax business purpose. These are powerful and straightforward approaches to attacking "bad behavior" that states are using successfully. If a taxpayer does something "tricky" to reduce taxes, it should be attacked "for being tricky" through the use of the myriad tools that the federal, state, and local governments now have and will continue to have.

Questions Posed by Congressman Coble

1. *If a company believes that they are being unduly harassed by a state tax jurisdiction, what recourse do they have under current law to seek relief?*

There are few remedies for taxpayers that feel unduly harassed. While many states have enacted so-called "taxpayer bill of rights," these provisions look impressive on the state revenue agency's website but in reality do not have much "teeth" and do not provide much protection. Even adjudicatory processes offer little hope for taxpayers. Often, the first step in the process is the last opportunity for a plenary (*de novo*) hearing and the hearing is held either by the same executive branch agency that took action against the business or in a sister agency. State judicial courts usually grant enormous deference to the state agency. And federal courts are virtually unavailable to address state tax controversies (Tax Injunction Act, 28 U.S.C. § 1341). In addition to these "due process" concerns, businesses in some states can challenge revenue department assessments only after paying any disputed tax and filing a claim for a refund (i.e.,

[4] *See* Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965).

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"pay-to-play"). In many instances, businesses would rather pay the tax than continue to incur expenses associated with contesting unfair and aggressive positions of state tax officials.

2. *In your opinion would H.R. 3220 change this process? Do you believe the bill includes increased protections for businesses that believe they are victims of over-aggressive state tax collectors?*

HR 3220 does not attempt to address the procedural, due process concerns raised above. In fact, doing so would incur significant opposition from states as an infringement on state sovereignty and the ability of state governments to establish their own administrative remedies. Nevertheless, by providing a "bright line" test in one area of constant contentious controversy, the scope of the controversy is narrowed considerably and the number of disputes will diminish accordingly.

I hope these responses are helpful. As always, I stand ready to assist the Subcommittee and you in any way I can.

Sincerely,

Arthur R. Rosen

NYK 907153-7.052903.0011

RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED BY JAMIE VAN FOSSEN

June 10, 2004

Honorable Chris Cannon, M.C.
118 Cannon House Office Bldg.
Washington, D.C. 20515

Dear Congressman Cannon,

Greetings.

Enclosed please find my responses to questions brought up after the May 13th, 2004 hearing on Business Activity Taxes (H.R. 3220).

I want to thank you again for the opportunity to present my support for your legislation. I look forward to working with you to preserve federalism. Please let me know if I can be of further assistance.

Yours truly,

Jamie Van Fossen
State Representative
Chair, Iowa House Ways & Means Committee
Public Sector Chair, ALEC Tax & Fiscal Policy Task Force

Enclosure: Q & A response

Cc:
Diane Taylor
Chris Atkins
Mike DeConti

PLEASE COMMENT ON COMMISSIONER CLAYBAUGH'S REMARKS THAT H.R. 3220 FAVORS BIG BUSINESSES OVER SMALL BUSINESSES

H.R. 3220 would be good for all businesses, big and small. While it would simplify the business activity tax obligation for all businesses, it would alleviate a more significant burden for smaller businesses, who cannot afford to have customers in other states if they have to pay corporate income taxes in all those states. Large companies will continue to participate in interstate commerce whether H.R. 3220 is enacted or not, because they have the resources to combat overaggressive actions by state revenue departments. We are already seeing reports of smaller businesses refusing to have customers in some states, however, because of these aggressive actions. Small business just cannot afford the risk associated with doing business in some states. Thus, H.R. 3220 would create more fair competition between small and large businesses.

IN YOUR OPINION, WILL H.R. 3220 CREATE COMPETITIVE DISADVANTAGES TO IN-STATE BUSINESSES?

The codification of the physical presence standard would actually level the playing field between in-state and out-of-state businesses, allowing them to compete for customers in all the states. What would truly be bad for in-state businesses would be a patchwork system where some states tax based on physical presence and some states tax based on economic presence. Congress needs to enact H.R. 3220 because it would provide a uniform treatment for all multistate businesses-large or small-engaged in interstate commerce.

H.R. 3220 can only be said to favor in-state businesses if you grant the premise that the current practices of many state revenue departments-taxing multistate businesses based on economic presence-are sound from a constitutional and policy perspective. Economic presence has never been the standard of multistate taxation of business income, so the premise relied on by opponents of H.R. 3220 should not be granted. H.R. 3220 would codify standard practice throughout United States history.

WOULD H.R. 3220 PERMIT CORPORATIONS TO RESTRUCTURE THEIR OPERATIONS TO AVOID TAX?

The U.S. Constitution is not a tax shelter. H.R. 3220 embodies the constitutional obligation of Congress to ensure and promote the free flow of commerce among the states. A physical presence nexus requirement promotes a freer flow of interstate commerce than an economic nexus requirement, because most businesses have physical presence in fewer states than they have economic nexus. H.R. 3220 thus promotes a simple and fair model for state taxation of multistate businesses.

DOES H.R. 3220 INFRINGE UPON STATE SOVEREIGNTY?

No. States do not have jurisdiction over interstate commerce. Congress has the responsibility to protect the free flow of interstate commerce. The current aggressive actions by certain state revenue departments are placing an undue burden on the free flow of commerce among the states. States cannot hide behind sovereignty to defend their actions. All governmental power has limits in our American system, including the power of states to raise taxes.

RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED BY RICK CLAYBURGH

QUESTIONS FROM REP. CANNON

1. Please provide a response to the request at the hearing for the appropriate alternative to the physical-presence nexus standard by which States could impose business activity taxes.

Response:

Under the U.S. Constitution and the overwhelming majority of state laws, a state can impose business activity taxes on companies that are "doing business" in the state without regard to whether that business is conducted through a physical presence or other means. P.L. 86–272, which applies to state income taxes, is the only national exception to the "doing business" standard.

The National Governors' Association believes that to the extent there is an issue to be addressed it is best addressed by the states. Sovereignty over state taxing authority is a critical element through which states accomplish key tax policy goals including funding state programs and services, and structuring economic systems to promote fair competition and economic growth. Federal preemption of state taxing authority like that epitomized by H.R. 3220 would upset the delicate economic balance between and among states and eventually affect national and international economies as well. Congress should not interfere with states' ability to analyze and adjust to the new economy by examining the effect of existing statutes on business, the potential economic gain or loss from proposals to alter existing statutes, or their discretion to work with the business community to resolve existing differences.

2. You stated in your oral testimony that HR 3220 encourages and expands "tax planning," and in your written statement that the bill "legalizes and even promotes increased tax sheltering." In assessing whether HR 3220 will result in state revenue loss due to tax sheltering, how do you view what constitutes a "tax shelter?" Do you consider a "tax shelter" anything which reduces a taxpayer's tax liability that is not attributable to changes in explicitly articulated tax policy? Isn't legal tax planning a normal and legitimate business activity?

Response:

"Tax sheltering," for state income tax purposes, means that an enterprise's income is not being fully reported to a state in a manner that fairly represents the business activity actually being conducted the enterprise in that state. Tax sheltering occurs when an enterprise creates structures and transactions that artificially shift income away from the state where income was earned—as determined by where the enterprise uses its property, employs people or makes sales—to some other state or a foreign jurisdiction. Income tax sheltering may include understating or shifting income through transactions that lack economic substance or that fail to conform to applicable law. In the context of gross receipts taxes, sheltering is accomplished through the creation of structures and transactions that artificially shift receipts away from the state where the sales were made. States generally do not consider efforts by companies to report income or receipts in a manner that does not fairly represent the business activities in the state to be "normal and legitimate."

Tax sheltering contrasts with legitimate tax planning whereby a company changes the actual location or nature of its real economic activity to minimize its tax burden often by taking advantage of favorable tax rates or exemptions offered by jurisdictions. Changing the "real economic activity" means generally changing the location where an enterprise uses its property, employees or other representatives or where it markets its products and services to customers. No one quarrels with legitimate tax planning that reflects actual changes in the location of real economic activity.

3. Please provide a response to the remarks of Mr. Rosen that States have ample legal tools to combat improper tax sheltering activities by businesses.

Response

The "legal tools" cited at the hearing are neither universal nor sufficient to mitigate the damage that H.R. 3220 would inflict on state tax systems. One of these so-called "tools" is known as "combined reporting", a filing method whereby a company is required to calculate and apportion income among the states jointly for affiliates that, in reality, comprise a single economic enterprise. Sixteen states use combined reporting as their general, mandatory filing method. However, this method is typically limited only to domestic affiliates. While combined reporting can correct tax sheltering conducted through domestic intangible holding company affiliates, it cannot reach affiliates set up in off-shore tax havens. More importantly, combined reporting would do nothing to correct tax sheltering through the use of the safe harbors in H.R. 3220, which would allow companies to engage in major activities in a state through protected entities. H.R. 3220, by greatly expanding tax sheltering through safe harbor entities, would significantly reduce the effectiveness of combined reporting as method of requiring income to be reported to the states where the income was actually earned.

States have one additional tool-royalty, interest and other expense deduction disallowance laws. Like combined reporting, these laws can be used to curb abusive transactions involving intangible holding companies. This tool was recently adopted in some states and has not been fully tested. Disallowance provisions would not remedy the damage caused by the H.R. 3220 physical presence safe harbors.

4. In your testimony you stated that HR 3220 would reduce every State's revenue base, with "aggregate revenue losses likely reaching into the billions of dollars per year." Will the NGA produce a formal study on HR 3220? If so, what methodology will be employed for measuring whether the bill will result in state tax revenue losses?

Response:

The National Governors Association is currently working with all states to conduct a comprehensive survey of the potential impact of HR 3220. We expect work on this survey to be completed soon. Following completion of the survey, we would be happy to discuss the results with Members of the Subcommittee.

QUESTIONS FROM REP. COBLE

1. Would you agree that there are cases in which state taxing jurisdictions have unfairly and/or aggressively sought payment of businesses activity taxes without basis?

Response:

State taxing authorities do not seek payments of business taxes without any basis. Rather they enforce their laws within the framework of their laws and regulations and the U.S. and their state constitutions. Without question there have been cases involving legitimate disagreements between state tax agencies and companies over whether taxes are due. To our knowledge however, there is no evidence of a systemic problem that would warrant Congressional intervention over state taxing authority

2. If so and with the understanding that you oppose HR 3220, what do you suggest be done to address such abuses?

Response:

As stated previously, the National Governors' Association has no evidence that states or state taxing authorities apply taxes without any basis. State tax administrators take pride in insuring that the tax laws of their state are properly and fairly applied to all businesses operating in the state. When a business or individual believes it is not being properly treated by a tax agency, it should first bring the issue to the attention of the tax agency. Most often (and likely evidenced by the lack of current examples presented at the May 13 hearing) these types of issues are handled amicably and to the satisfaction of both the taxpayer and the state. If the dispute continues, every state provides for a form of administrative and judicial review to hear complaints and provide appropriate remedies.

Smithfield

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PRIVATE

June 8, 2004

Ms. Diane K. Taylor, Counsel
House Judiciary Committee
Subcommittee on Commercial and Administrative Law
B353 Rayburn House Office Building
Washington, D.C. 20515

Dear Diane:

I write to express my great appreciation for the opportunity to address the House Judiciary Committee, Subcommittee for Commercial and Administrative Law hearing on H.R. 3220, held on Thursday, May 13, 2004. The issue of simplifying business activity taxes is extremely important and vital to the American economy. All businesses require certainty on the subject of state taxation. Smithfield Foods, Inc. supports H.R. 3220 because it will provide simplification and certainty regarding state taxes for multi-state taxpayers.

I am also pleased to respond to various questions from Chairman Chris Cannon and Representative Howard Coble detailed in Chairman Cannon's letter dated May 21, 2004. My responses are provided below.

Questions from Chairman Cannon:

1. *Please comment on Commissioner Clayburgh's remarks that H.R. 3220 favors big businesses over small business. In your opinion, how will smaller companies fare if faced with continued uncertainty regarding the appropriate nexus standard for the imposition of business activity taxes?*

   Small companies are afforded the same benefits and protections under H.R. 3220 as that of large corporations. H.R. 3220 has no provisions that implicitly or explicitly benefit or harm any business based on size or industry. H.R. 3220 codifies the Constitutional protections currently afforded to all companies.

   Many small businesses are multi-state taxpayers, just like Smithfield Foods. Take for example a one-person software company operating from a home in Virginia, which licenses its software to a customer in New Jersey. Similarly, Smithfield manufactures food product in Virginia and sells it to a customer in New Jersey. Both transactions are the result of physical activities in Virginia but not New

Jersey. However, current New Jersey law will tax both transactions, even though neither one is the result of physical activities or presence in New Jersey.

H.R. 3220 will establish a bright-line standard that will apply to both companies in the above example. Both small and large companies will benefit from the physical nexus standards established by H.R. 3220.

Because they often lack the in-house legal and other resources of large companies, small companies are often most affected by aggressive state tax policies. This, in turn, is likely to have a chilling effect on the success of these small, often start-up, businesses that are a driving force in today's economy. In this way, H.R. 3220 provides very important protection for small companies that can be overwhelmed by demands for tax filings in hundreds of jurisdictions with which they have only the most minor contacts. The same protection would relieve larger companies of what has become an increasingly expensive burden.

2. *Please respond to Commissioner Clayburgh's remarks that H.R. 3220 legalizes and promotes tax sheltering activities.*

   H.R. 3220 is designed to provide clarity to an area of state taxation that is currently impaired by inconsistencies, confusion, and misinterpretations. H.R. 3220 will render many state tax planning concepts obsolete and unnecessary. State tax planning will be reduced, not expanded, as a result of H.R. 3220.

3. *Is physical-presence the appropriate standard for establishing nexus? Why or why not?*

   The U.S. government currently uses the "permanent establishment" theory (also known as "P.E.") to impose taxes in the international arena. The P.E. concept uses physical presence as the basis for imposing taxation. The U.S. has numerous international tax treaties that employ the P.E. concept. The idea is that a permanent establishment consisting of employees, plants, offices and other physical equipment creates a taxable presence. With such clear rules in place, no taxpayer can easily question the imposition of tax when it has such items in a particular state.

   H.R. 3220 mirrors the physical presence requirements of many U.S. tax treaties and the OECD's permanent establishment guidelines. The P.E. concept is grounded in existing tax policy and we believe it should be considered as the basis for imposing state taxation. This will also provide Federal/State tax harmony for the U.S.'s trading partners.

Questions from Representative Howard Coble:

1. *Even with enactment of H.R. 3220 and the adoption of the bright-line test, is it your opinion that businesses and states would continue to differ over when business activity taxes should be assessed?*

   Differences between states and businesses on the issue of when business activity taxes should be assessed may be attributed to the fact that each and every state is largely free to provide its own, unique interpretation of the scope and boundaries of these taxes. Congress enacted Public Law 86-272 shortly after the Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota*. Since Public Law 86-272 was enacted, there have been a number of court cases seeking to define its contours with greater precision. H.R. 3220 serves to clarify Public Law 86-272 and should thereby reduce the need for litigation. As reflected below, another way to reduce litigation is to provide access to federal courts. This would establish a nation-wide body of law, instead of leaving each state to interpret applicable federal laws in its "home court," and discourage overly aggressive assessment policies by taxing authorities.

2. *In your opinion and experiences, is the current venue of challenging tax assessments through the state courts fair to out-of-state businesses? Would you support making federal courts available to hear state tax assessment cases?*

   There have been numerous tax assessment cases litigated at the state level. However, it is only when a case has gone to the highest state court that the case may be appealed to the Federal court system, and then only to the United States Supreme Court where the number of decisions is necessarily limited. *Quill Corporation v. North Dakota* is just one leading example where a company has had to proceed through the state court system to the federal court system in order to reach a decision that takes into account both state and federal laws and interests.

   The Congress has previously seen the necessity of providing access to Federal courts for certain key industries which historically were subject to discriminatory tax treatment by local tax authorities. The railroad, airline, and trucking industries are good examples of this and the importance of granting access to the Federal Courts in certain state and local tax disputes.

   Smithfield Foods strongly supports granting Federal courts jurisdiction to hear cases arising under H.R. 3220 and otherwise challenging "nexus" under the Constitution and Federal law. Many jurisdictions in the United States are known for assessing taxes based on the barest of contacts and telling the taxpayer to travel long distances to prove it is not subject to the tax. Too often this tactic is employed by independent firms working on a contingent fee basis for the taxing authority, a circumstance that hardly allows for a fair review. Providing access to

Federal courts in such matters simply provides a level playing field with respect to issues that are vital to a healthy national economy.

Assuming access is granted to Federal courts to hear cases contesting the jurisdiction under Federal law of a state or local government to assess a tax, consideration should be given to providing a streamlined and efficient process consistent with the importance of not letting aggressive assessment practices burden commerce. Especially in matters arising under H.R. 3220, which provides lack of physical presence as a defense to assessments, placing venue in such matters in the district of the taxpayer's principal place of business would be appropriate.

Scholars have explored the question of parity in federal and state courts; however, there is no systematic study on the issue with regard to state taxation cases. Whether federal and state courts hear state tax assessment cases, litigation in any court system presents both sides with a costly way to resolve disputes over an issue that may be more quickly and effectively resolved through legislation, such as that presented by H.R. 3220.

Smithfield Foods appreciates the opportunity to discuss H.R. 3220 and the important national tax policy issues it addresses. Please feel free to call me at 757-357-8190 with any questions.

Sincerely,

V. T. Turner

Vernon T. Turner
Corporate Tax Director

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PREPARED STATEMENT OF CONGRESSMAN GREGORY W. MEEKS (NY-06)

Mr. Chairman, Ranking Member Watt, and my fellow Members of Congress:

I thank you for allowing me the opportunity to join you today. Although I do not sit on this Committee, I feel strongly about the legislation at hand, and I am appreciative that you have allowed me to join in today's discussion. I would also like to make note of my gratitude to Congressmen Boucher and Goodlatte who have led the effort in business activity tax nexus clarification for several years.

H.R. 3220, The Business Activity Tax Simplification Act, would provide a consistent, national jurisdictional standard for the imposition of state and local business activity taxes on interstate commerce. As you know, the legislation addresses the need to clarify and modernize the nexus rules that govern the states' ability to impose business activity taxes on companies that do not have a physical presence in the taxing jurisdiction.

In recent years, many of our states have found themselves in economic crunches. These circumstances have led some states to look outside of their borders and seek payment of income-based taxes from companies that are not physically present in their jurisdiction. This bill would clarify that physical presence is the constitutional standard for imposition of business activity taxes and establish a bright-line physical presence nexus standard. Businesses would continue to pay business activity taxes in the jurisdictions where they receive direct benefits. This legislation would merely clarify the states' existing authority to tax interstate commerce, not impose any new restrictions on the states' taxing power.

The benefactors of this legislation are people we, as policymakers, have to answer to directly. It is our responsibility to identify and rectify potential barriers to new job creation in America. We must ensure that economic expansion creates the largest number of high-quality jobs for those we represent. Should the current level of uncertainty and ambiguity of state-level taxes continue, new job creation will be impeded.

I am a Congressman from the state of New York. New York has a strong tax base that we have worked very hard to acquire. For example, we are home to many of the country's leading media companies and financial institutions. In recent years, New York companies have been unfairly attacked by other states in search of increased revenues. For example, some states have alleged that income-based taxes are due from media corporations simply because they broadcast programs into the state. Other states have attempted to impose income-based taxes on banks based only on the fact that they have issued credit cards to people in the taxing state. States are taking advantage of the current "grey area." The appropriate nexus standard needs to be clarified, so that taxpayers and states can have certainty with respect to taxes due.

In conclusion, this legislation will ensure fairness, minimize litigation, and create the kind of legally certain and stable business climate that encourages businesses to make investments, expand interstate commerce, grow the economy and create new jobs.

For these reasons, I strongly support this bill and look forward to the testimony of today's witnesses.

To strengthen And promote cities as centers of opportunity, leadership, and governance.

National League of Cities

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Washington, D.C. 20004-1763
202-626-3000
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May 21, 2004

The Honorable Chris Cannon, Chairman
The Honorable Melvin Watt, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
Washington, DC 20515

Dear Chairman Cannon and Ranking Member Watt:

On behalf of more than 18,000 cities and towns represented by the National League of Cities (NLC), I am writing to express our opposition to H.R. 3220, the "Business Activity Tax Simplification Act." If this legislation is enacted, states and local governments could lose a substantial portion of the more than $60 billion in annual business activity revenues, which are critical for public safety, education, transportation, and other public services that benefit businesses and citizens.

The primary impact of H.R. 3220 will be to legalize in federal law a variety of corporate tax planning techniques that some companies attempt to use to minimize their state and local tax burden. More specifically, the legislation would attempt to change the current "economic presence standard" for business activity to a substantial "physical presence standard," thereby restricting state and local tax authority. The physical presence provisions in H.R. 3220 would also place local businesses, including manufacturers, at a competitive disadvantage by giving tax breaks to out-of-state businesses that operate within a state and/or political subdivision.

Additionally, H.R. 3220 would be wholly inconsistent with Congress's efforts to close tax loopholes and strengthen corporate accountability measures by changing guidelines which determine the imposition of business activity taxes. According to a recent Congressional Research Service report, this legislation would increase opportunities for tax planning leading to more "nowhere income" as well as "tax avoidance and possibly evasion." Certainly, state and local efforts to overcome sheltering techniques will be nullified by a federal law imposing a physical presence standard for business activity taxes.

The Honorable Chris Cannon, Chairman
The Honorable Melvin Watt, Ranking Member
May 12, 2004
Page Two

NLC urges you to oppose H.R. 3220 and preserve the ability of state and local governments to continue to provide essential services to local residents and businesses. Please contact Juan Otero at 202-626-3023 if you have any questions, and we look forward to working with you on this critical issue in the near future.

Very truly yours,

Donald J. Borut
Executive Director

cc: House Judiciary Committee

Order Code RL32297

CRS Report for Congress

Received through the CRS Web

State Corporate Income Taxes: A Description and Analysis

March 23, 2004

Steven Maguire
Analyst in Public Finance
Government and Finance Division

State Corporate Income Taxes: A Description and Analysis

Summary

Recently, state corporate income taxes have become the subject of renewed interest to both state and federal policymakers. The cause of this elevated interest may be the gradual decline in revenue generated by the tax, the expansion of electronic commerce, and/or federal tax policy that affects state corporate income taxes. Congress has had a role in state corporate income taxes for at least two reasons: (1) interstate commerce regulatory oversight and (2) federal and state corporate income tax interaction. Congress may become more involved in state corporate tax issues because of recent changes in interstate commerce and how states administer corporate taxes.

The state corporate income tax is not a major source of revenue for states, but is still an important contributor to state finances. Over the last decade, state corporate income taxes generated approximately 5% of state tax revenue. However, the revenue generated by the tax — measured as a percentage of state gross domestic product — has been gradually declining. Several explanations have been offered for this gradual decline including (1) state policy decisions to lower the tax burden on corporations; (2) aggressive tax planning by corporations; (3) broad economic cycles diminishing the base; and (4) federal corporate income tax policy. Most research has identified the first two factors as the primary cause for the recent decline.

Many corporations operate in multiple tax jurisdictions which makes the state corporate income tax a relatively complex tax to administer. The base of the corporate income tax (net income or profits) must be fairly apportioned to all of the states where the firm has established a presence (or nexus). A mosaic of nexus standards has been created through multistate tax compacts, state and federal legal decisions, and congressional actions. At present, there is not a uniform definition of taxable profits or a uniform method of apportioning income.

Legislation has been introduced in the 108th Congress that is intended to address some of the issues identified above. Nexus issues are addressed in what has been identified as "streamlining" legislation, H.R. 3184 and S. 1736. Generally, the streamlining legislation would allow states to compel out-of-state vendors to collect sales and use taxes even if the out-of-state vendor does not have nexus in the taxing state. Participating states would have to simplify sales and use taxes before Congress would confer collection enforcement authority. Interstate commerce has complicated the nexus issue for sales and use tax administration and how this issue is resolved may have broader implications for state corporate income taxes.

Legislation has also been introduced that addresses nexus issues for state corporate income taxes directly, sometimes identified as "brightline" legislation. H.R. 3220 would establish more uniform standards — generally higher standards — for the level of business activity that would trigger nexus and thus corporate income taxability. The legislation, however, would not clarify or standardize state corporate income tax apportionment formulas or the definition of taxable income. This report will be updated as legislative events warrant.

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State Corporate Income Taxes: A Description and Analysis

Congressional interest in state corporate income taxes arises from two distinct issues. First, Congress has a direct role in the oversight and regulation of interstate economic activity. State taxation of multi-state corporations would certainly be included in this jurisdiction. Second, federal corporate income tax policy changes have a direct effect on state (and local) tax structure.[1] Congressional activity, or in some cases inactivity, in these two areas can have a pronounced effect on state budget decisions. After an overview of state corporate income taxes, this report analyzes both the interstate commerce oversight and tax interaction issues. The last section of the report describes and analyzes current legislation that would affect state corporate income taxes.

State Corporate Income Taxes: Background

For most observers, state corporate income taxes are the most familiar state tax that businesses pay. However, corporate income taxes generated less than 5% of total state tax revenue in 2002. In contrast, general sales and use taxes, of which businesses pay a large portion, accounted for approximately 33% of state tax revenue.[2] Even though state corporate income taxes represent a relatively small portion of total state tax revenue in most states, the state corporate income tax still generated almost $26 billion in 2002. And, in some states, the corporate income tax contributes a much larger share of total tax revenue. For example, from 1992 to 2002, the corporate income tax averaged approximately 18.9% of total state tax revenue in New Hampshire. In contrast, the corporate income tax contributed 3.6% of total tax revenue in Oklahoma.[3]

As New Hampshire and Oklahoma show, the dependence on corporate income taxes varies considerably from state to state; thus, federal corporate income tax policy does not have a uniform effect on all states. The remainder of this section describes

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[1] State taxation of international firms and individuals is also of interest to Congress. International tax policy, however, extends beyond the scope of this report.

[2] Data are CRS calculations based on U.S. Census of Governments data. These data is available at the following website: [http://www.census.gov/govs/www/statetax.html]. Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, "Total State and Local Business Taxes: Fiscal Update," *State Tax Notes*, October 20, 2003, estimated that businesses paid approximately 43% of total state and local taxes. A separate estimate of the portion of total sales tax revenue collected from businesses was not provided.

[3] CRS calculations based on U.S. Census of Governments data; see above for website link.

the mechanics behind state corporate income taxes, highlighting the differences among states. Understanding the nuances of state corporate income taxes is necessary for a complete discussion and analysis of interstate commerce issues and the link between federal and state tax policy.

The Mechanics of the State Corporate Income Tax

Generally, the state corporate income tax is levied on the accounting profits of a corporation.[4] The portion of profit that can be attributed to a state serves as the base for that state's corporate income tax. Profits are allocated to a state based on the amount of economic activity that occurs in that state. Following is a more detailed description of the state corporate income tax structure.

Federal Starting Point. Most states and the District of Columbia incorporate the federal income tax code as currently amended (20 states) or as of a specific date (17 states).[5] The remaining states typically use a measure of income that closely follows the federal definition of taxable income. Using the federal starting point likely eases the compliance burden for corporations, particularly those that have nexus in several states. Nevertheless, many states still require corporations to "add-back" to income exclusions that are allowed under federal corporate income tax rules.[6]

The Uniform Division of Income for Tax Purposes Act (UDITPA). The Uniform Division of Income for Tax Purposes Act (UDITPA) is a model act drafted and adopted by the Commissioners on Uniform State Laws and the American Bar Association. The Act sets standards for separating income into business income, which is apportioned to states, and non-business income, which is allocated entirely to the entity's home state. Generally, non-business income is defined as passive income on corporate owned assets; income from these assets could include dividends, rents, and royalties. Corporations could avoid paying taxes on non-business income by locating in states without a corporate income tax.[7] Some states, through the Multistate Tax Compact (MTC), have voluntarily adopted uniform rules and procedures for the allocation and apportionment of income — as defined under UDITPA — to ease the compliance burden on multistate businesses.[8] Many of the

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[4] Net income is revenue less expenses, which is roughly equivalent to pre-tax accounting profits.

[5] These 37 states directly incorporate the federal tax code, however, all states except for Arkansas and Mississippi, use federal income for the starting point for purposes of calculating income tax liability.

[6] Bureau of National Affairs, "Multistate Tax Report: 2003 Survey of State Tax Departments," vol. 10, no. 4, April 25, 2003. This report identifies the add-backs and other special corporate income tax rules for each state.

[7] A "throwback" or unitary accounting rules would limit this type of tax planning to avoid taxation of non-business income.

[8] According to the Commerce Clearing House (CCH) publication, State Corporate Income Tax Guide, seven states have enacted UDITPA as written and 12 more states have adopted (continued...)

states that have not formally adopted UDITPA standards still closely adhere to the UDITPA standards.

The Apportionment Formula. Typically, three factors of economic activity are used in the apportionment formula to measure the economic presence of a firm in a state: the percentage of property, the percentage of sales, and the percentage of payroll. Not all states weigh factors equally; some over-weight sales or use only sales to allocate income (often called single-factor sales apportionment). In theory, the weighting should accurately portray the economic presence of the firm. There is no consensus on the definition of "economic presence," and hence there is variation among state apportionment formulas.

Some analysts have suggested that a formula that double-weights sales is the ideal formula because it gives equal weight to input factors (property and payroll), and an output factor (sales).[9] Others have argued that the business tax should be levied based on the business's use of government services provided by the firm's resident state. For example, a corporate income tax that is levied according to the value of one input only, such as property, could be justified because the value of property is closely related to the level of government services provided to the business by the home state. However, corporations also receive benefits from an out-of-state customer's well functioning legal system and public infrastructure. An apportionment formula that includes just the property factor would not compensate the out-of-state customer's government for the benefit to the corporation of those public services.

The general form of the apportionment formula is reproduced below. The superscript *i* represents the profits (π), sales (s), property (p), and labor (l), a state attributes to the i-th firm. The superscript T represents the total value of each factor and profits for the firm in a given tax year. The subscript w represents the weight of each respective factor as defined by state law; the weights sum to one.

$$\pi^i = \pi^T \times \left[\left(\frac{s^i}{s^T} \right) \times w_s + \left(\frac{p^i}{p^T} \right) \times w_p + \left(\frac{l^i}{l^T} \right) \times w_l \right]$$

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[8] (...continued)
UDITPA with some minor modifications.

[9] James Francis and Brian H. McGavin, "Market Versus Production States: An Economic Analysis of Apportionment Principles," in *State Taxation of Business: Issues and Policy Options*, Thomas Pogue, ed. (New York: Praeger Publishers, 1992), p. 61.

For example, states that use an even-weight formula would use 0.33 for each w, meaning each factor contributes equally to the determination of profits attributable to a state. If the state were to "double-weight" sales, that means that the w_s is twice the amount of each of the other two weights. In the case of double-weight sales, w_s=0.50; w_p=0.25; and w_l=0.25.

Nexus. The apportionment formula does not imply that a business that sells goods and services into a state, owes taxes to that state. A state can levy a corporate income tax on a business only if the business maintains a substantial nexus in the state. The nexus rules governing the corporate income tax were partially circumscribed by Congress through P.L. 86-272, (the Act). The Act established that the mere solicitation of the sale of *tangible* goods by a firm in a state was not substantial nexus for corporate income tax purposes. However, for intangible goods and services, there is significant variation from state to state in how physical presence is defined.

The Bureau of National Affairs periodically surveys state revenue departments about activities that could create nexus.[10] The responses highlight the differential treatment from state-to-state of business activities deemed to create nexus. For example, according to the report, 24 states reported that an out-of-state corporation that reimbursed its in-state salespersons had established nexus whereas 19 states reported that activity would not. Establishing a web server in a state created nexus in 16 states whereas 23 states did not indicate that maintaining a web server would establish nexus.

Throwback Rule. Because of the state-by-state variation in nexus rules, the first step for corporations before apportioning income is to determine the states where the firm has established nexus. The firm then allocates profits to these states based on each respective state's apportionment formula. The different state apportionment formulas and nexus rules, however, often lead to what is termed "nowhere income."[11] Nowhere income arises because not all states have the same apportionment formula and some states do not levy a corporate income tax. For this reason, some states impose corporate income tax rules that stipulate that all sales to customers in states that do not tax the sales (through a corporate income tax) are "thrown back" to the home state.

For example, a California firm that sells goods to customers in Nevada — which does not have a corporate income tax — would include Nevada sales in the numerator of the sales factor component of the California apportionment formula. If Nevada had a corporate income tax with a sales factor in the apportionment formula, California would not require the firm to include the Nevada sales in the California corporate income tax apportionment formula. The throwback rule is

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[10] Bureau of National Affairs, "Multistate Tax Report: 2003 Survey of State Tax Departments," vol. 10, no. 4, April 25, 2003.

[11] The converse is also true. Income could also be *overtaxed* because of the variety of apportionment formulas employed by states.

applied in 23 states and the District of Columbia; 22 states do not impose a throwback rule; and five states do not impose a corporate income tax.[12]

State Apportionment Formulas. **Table 1** groups states based on their corporate income tax apportionment formula. "Even-weight" implies that the each factor is weighted the same or one-third. The hybrid arrangements allow firms to choose the type of apportionment scheme that minimizes tax burden or instructs the firm to use different types of allocation based on the source of income. The most common apportionment formula is the double weighted sales scheme.

Table 1. State Corporate Income Tax Apportionment Formulas

Apportionment Scheme (number of states)	States
Even-weight (11)	Alabama, Alaska, Delaware, District of Columbia, Hawaii, Kansas, Montana, North Dakota, Rhode Island, Utah, and Vermont.
Even-weight hybrid (3)	Missouri, firms choose either even weight or single factor sales; New Mexico, certain manufacturing firms can choose double-weight sales, otherwise even-weight; Oklahoma, firms meeting certain investment criteria can choose double-weight sales, otherwise even-weight.
Double-weight sales (19)	Arizona, Arkansas, California, Florida, Georgia, Idaho, Indiana, Kentucky, Louisiana, Maine, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Tennessee, Virginia, West Virginia, Wisconsin.
Double-weight sales hybrid (3)	Connecticut, double-weight sales for income derived from the sale or use of tangible personal or real property, single-factor sales for other income; Maryland, manufacturers use single-factor sales, otherwise double-weight sales; South Carolina, double-weight sales for manufacturers and dealers in tangible personal property, otherwise single-factor sales.
Single-factor sales (3)	Illinois, Iowa, and Nebraska.
Other weight allocations (5)	(in percentages, sales- payroll-property) Michigan, 90-5-5; Minnesota, 75-12.5-12.5; Ohio, 60-20-20; Oregon, 80-10-10; and Pennsylvania, 60-20-20.
Other hybrids (2)	Colorado, firms choose between a three-factor even-weight and a two-factor (sales and property) even-weight; Mississippi, retailers, wholesalers, service companies, lessors use single-factor sales, wholesale manufacturers use even-weight three factor, retail manufacturers use three-factor, double-weighted sales.
No general corporate net income tax (5)	Nevada, South Dakota (bank & financial corporation excise tax), Texas (gross receipts tax), Washington, and Wyoming.

Source: Commerce Clearing House, Multistate Corporate Income Tax Guide.

[12] Commerce Clearing House, *2004 State Tax Handbook*, p. 330.

State Corporate Income Tax Rates. Rates on corporate income taxes vary considerably. The state with highest rate, Iowa, taxes all taxable income in excess of $250,000 at 12%. Iowa is also one of three states (Nebraska and Illinois being the others) that use a single-factor sales apportionment formula. The rates for each state are listed on the following page in **Table 2**. The highest marginal rates listed in **Table 2** do not necessarily represent the relative burden of state corporate income taxes in each state. The best measure of the relative corporate income tax burden for each state is the *average effective* marginal tax rate (AEMTR). The AEMTR would incorporate differences among states in the definition of taxable income. Nevertheless, the marginal rates do provide some information about the relative burden of corporate income taxes across states.

Table 2. State Corporate Income Tax Rates

State	Highest Rate	Number of Rates	State	Highest Rate	Number of Rates
Alabama	6.500%	one	Montana	6.750%	one
Alaska	9.400%	multiple	Nebraska	7.810%	multiple
Arizona	6.968%	one	Nevada	no tax	n/a
Arkansas	6.500%	multiple	New Hampshire	8.500%	one
California	8.840%	one	New Jersey	9.000%	multiple
Colorado	4.630%	one	New Mexico	7.600%	multiple
Connecticut	7.500%	one	New York	7.500%	one
Delaware	8.700%	one	North Carolina	6.900%	one
D.C.[a]	9.975%	one	North Dakota	10.500%	multiple
Florida	5.500%	one	Ohio[e]	8.500%	multiple
Georgia	6.000%	one	Oklahoma	6.000%	one
Hawaii	6.400%	multiple	Oregon	6.600%	one
Idaho	7.600%	one	Pennsylvania	9.990%	one
Illinois[b]	4.800%	one	Rhode Island	9.000%	one
Indiana	8.500%	one	South Carolina	5.000%	one
Iowa	12.000%	multiple	South Dakota[f]	6.000%	multiple
Kansas	4.000%	one	Tennessee	6.500%	one
Kentucky	8.250%	multiple	Texas[g]	4.500%	one
Louisiana	8.000%	multiple	Utah	5.000%	one
Maine	8.930%	multiple	Vermont	9.750%	multiple
Maryland	7.000%	one	Virginia	6.000%	one
Massachusetts[c]	9.500%	one	Washington	no tax	n/a
Michigan	1.900%	one	West Virginia	9.000%	one
Minnesota[d]	9.800%	one	Wisconsin	7.900%	one
Mississippi	5.000%	multiple	Wyoming	no tax	n/a
Missouri	6.250%	one			

Source: Commerce Clearing House, 2004 State Tax Handbook.

[a] The D.C. rate is new beginning with the 2004 tax year.
[b] S Corporations, partnerships, and trusts are taxed at a maximum 6.3% rate.
[c] Financial institution net income is taxed at 10.5%. Corporations also pay a surtax on property located in Massachusetts and not taxed at the local level.
[d] Minnesota also levies a fee based on the total payroll, property, and sales of the corporation. The fee raises the maximum tax rate and creates very slight progressivity.
[e] Ohio allows firms to choose an alternative of four mills (or 0.4%) multiplied by taxable net worth.
[f] South Dakota taxes only banks and financial institutions. The rates fall as net income rises from a high of 6.0% for the first $400 million to 0.25% for the amount over $1.2 billion.
[g] Texas taxes "net taxable earned surplus" and adds a surtax of 0.25% on net taxable capital.

State Corporate Income Tax Revenue: 1992 to 2002

According to the U.S. Census Bureau, state tax revenue from state corporate income taxes grew from 1992 through 2000, then declined in 2001 and 2002. However, as a portion of gross state product (GSP is an approximate measure of state economic activity), corporate tax revenue has declined almost every year over the 1992 to 2002 time frame. **Table 3** reports state corporate tax revenue and GSP for states that impose a state corporate income tax.[13]

Table 3. State Corporate Income Tax Revenue and Gross State Product

Year	Total State Corporate Tax Revenue (in millions)	Total Gross State Product (GSP) (in millions)	State Corporate Tax Revenue as Percentage of GSP
1992	$21,851	$5,559,271	0.39%
1993	$24,208	$5,821,515	0.42%
1994	$25,498	$6,194,870	0.41%
1995	$29,075	$6,531,661	0.45%
1996	$29,316	$6,881,991	0.43%
1997	$30,718	$7,315,061	0.42%
1998	$31,089	$7,784,388	0.40%
1999	$30,766	$8,222,331	0.37%
2000	$32,522	$8,780,209	0.37%
2001	$31,687	$8,986,273	0.35%
2002	$25,888		

Source: CRS calculations based on U.S. Bureau of Census, Governments Division and Bureau of Economic Analysis.

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[13] The governments division of the Bureau of Census collects and reports state tax collections by type of tax based on survey information from the states.

Several causes have been suggested for the recent decline in state corporate tax revenues.[14] The most direct causes would be legislated changes in the tax rate, the tax base, or the compliance rules. The decline in revenue could be the result of state governments, in the aggregate, attempting to lower the tax burden on corporations. The December 2003 Fiscal Survey of States reported that states, in the aggregate, enacted net tax cuts every year from FY1995 through FY2001.[15] Even though these tax cuts were not separated into types of tax by the Fiscal Survey, it seems likely that state corporate income taxes were included in the tax cuts. Recent research has reached a similar conclusion, noting that "....[S]tate tax bases have deteriorated further than the federal base because of a combination of **explicit state actions** [emphasis added] and tax avoidance/evasion by businesses."[16]

A second explanation, alluded to above, is that corporations are more effectively avoiding, or even evading taxes through aggressive tax planning.[17] The Multistate Tax Commission (MTC) concluded in a recent study that "...various corporations are increasingly taking advantage of structural weakness and loopholes in the state corporate tax systems."[18] Again, the MTC study cannot definitively separate the revenue declines arising from policy changes and avoidance/evasion, but still concludes that tax avoidance and evasion is partly responsible for the decline in state corporate tax revenues.

A third explanation is that cyclical economic changes have led to the decline in state corporate tax revenues. Note that cyclical economic effects are unrelated to the behavior of policymakers or corporations. The effect of economic cycles on revenue is difficult to identify because the legislated changes and the corporate behavior described above likely exacerbated (or attenuated) the cyclical economic changes. Recent research into the causes of state budget deficits, suggested that "....the current [cumulative state] deficit is largely structural...."[19] The implication of this finding is that policy (structural) changes like tax cuts and discretionary spending increases generated state budget deficits in FY2002 and FY2003, not the machinations of the economic cycle.

Finally, changes to the federal corporate income tax code, which have reduced the base of most state corporate income tax systems, could explain part of the decline in state corporate income tax revenue. The next section discusses the interaction between federal and state corporate income taxes in more detail.

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[14] William F. Fox and LeAnn Luna, "State Corporate Tax Revenue Trends: Causes and Possible Solutions," *National Tax Journal*, vol. LV, no. 3, Sept. 2002, pp. 491-508.

[15] National Association of State Budget Officers, December 2003 Fiscal Survey of States.

[16] Fox and Luna, 2002, p. 498.

[17] Tax avoidance is a legal means of reducing tax liability, such as buying tax-exempt bonds. In contrast, tax evasion is illegal, such as not claiming otherwise taxable income.

[18] Multistate Tax Commission, "Corporate Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections," July 15, 2003, from the *Executive Summary*.

[19] Brian Knight, Andrea Kusko, and Laura Rubin, "Problems and Prospects for State and Local Governments," paper presented at Urban Institute Seminar, State Fiscal Crises: Causes, Consequences, and Solutions, April 5, 2003.

Issues for Congress

State corporate income taxes are of interest to Congress for primarily two reasons: interstate commerce oversight and tax interaction. The following section analyzes these two aspects of state corporate income taxation that are most directly affected by congressional action.

Interstate Commerce Regulation and Oversight

The interstate commerce regulation and tax interaction issues have attracted interest for three principal reasons: (1) the complex Internet sales tax debate; (2) the recent federal business tax cuts; and (3) state fiscal problems. The link between the Internet sales tax debate and state corporate income taxes is complicated and centers on the prohibition on states reaching beyond their borders to compel out-of-state vendors to collect sales and use taxes.[20] As a general rule, a state can require a vendor to collect sales and use taxes only if the vendor has "substantial nexus" in the state.[21] Typically, the substantial nexus standard is satisfied if the vendor has a physical presence in the state.[22] Thus, remote Internet transactions, where the vendor has no physical presence in the customer's home state, do not have the sales and use tax added to the price of the good by the vendor. These types of transactions have grown considerably over the last several years and have contributed to the erosion of the sales and use tax base of most states.[23]

In an effort to persuade Congress to allow states to compel remote vendors to collect use taxes, a coalition of states has been working together to establish a uniform sales and use tax agreement. The coalition of states identify this effort as the "Streamlined Sales and Use Tax Project." States that sign onto the sales tax compact would have already implemented uniform definitions and compliance rules, thus easing the administrative burden of remote vendor collection. Two bills in Congress would grant states these rights, S. 1736 and H.R. 3184. If these bills were enacted and the states satisfied the requirements for qualification, remote vendors in the compact states would collect use taxes for shipments to states where the vendor does not have a substantial nexus.

Some vendors are concerned that collecting use taxes for a state in which they do not have nexus, could trigger income or other business tax liability. However,

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[20] A *sales* tax is levied at the time of transaction and is tax on the sale. The companion *use* tax is a tax on the *use* of a good or service. Technically, remote vendors would collect a use tax because the product is going to be used in the customer's home state.

[21] The limitation arises from the due process and commerce clauses in the U.S. Constitution.

[22] For more on the sales tax issue, see CRS Report RL31252, *Internet Commerce and State Sales and Use Taxes*, by Steve Maguire.

[23] Donald Bruce and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," *Center for Business and Economic Research*, University of Tennessee, September 2001. Bruce and Fox estimated this erosion from electronic commerce alone will result in states losing approximately $24.2 billion in 2006 and $29.2 billion in 2011. There is considerable debate, however, about the size of the revenue loss.

past court decisions and the landmark P.L. 86-272 established physical presence as the standard for sufficient nexus for corporate income taxes for firms selling tangible goods. The law, P.L. 86-272, was passed shortly after the Supreme Court issued a ruling that seemed to offer an ambiguous definition of "sufficient nexus." The Supreme Court language that generated this concern (as cited in the Senate report on S. 2524, the Senate version of the eventual P.L. 86-272) is reproduced below:

> We conclude that the net income from the interstate operations of a foreign corporation may be subjected to State taxation provided the levy is not discriminatory and is properly apportioned to *local activities within the taxing State forming sufficient nexus to support the same.* [Emphasis added] (358 U.S. 450 at 452)[24]

The term "local activities" was deemed too ambiguous by policy makers and businesses. The Senate report provided the following as reasoning behind the enacted legislation (P.L. 86-272) that clarified the definition:

> Persons engaged in interstate commerce are in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient "nexus," that is, connection, with the State to support the imposition of a tax on net income from interstate operations and "properly apportioned" to the State.[25]

The legislation passed by Congress clarified nexus by identifying those activities which would *not* establish nexus. Generally, soliciting sales of tangible goods in a state for shipment by common carrier from locations outside the state into the state, would not be sufficient to trigger nexus. Thus, for tangible goods shipped across state lines, state net corporate income taxes are levied at the *source* not the *destination* of the product. The home state of the customer receiving the goods cannot levy a state corporate income tax on the remote business by virtue of the transaction. The issue of intangible goods and services was not addressed directly by P.L. 86-272.

The current Internet sales and use tax debate has revived a discussion of what constitutes nexus for a corporate income tax. Clarified nexus standards, as would be implemented in S. 1736 and H.R. 3184, however, do not seem destined to fundamentally alter the administration of state corporate income taxes. As noted above, current laws would already shield out-of-state vendors from corporate income tax liability if the business were only soliciting the sale of tangible goods into the state. As for intangibles goods and services, S. 1736 and H.R. 3184 include language

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[24] U.S. Congress, Senate Committee on Finance, *State Income Taxes — Interstate Commerce*, Senate report to accompany S. 2524, S.Rept. 658, 86th Cong., 1st sess. (Washington: GPO, Aug. 11, 1959) p. 2549.

[25] U.S. Congress, Senate Committee on Finance, *State Income Taxes — Interstate commerce*, Senate report to accompany S. 2524, S.Rept. 658, 86th Cong., 1st sess. (Washington: GPO, Aug. 11, 1959) p. 2549.

to ensure that a corporation would not establish nexus by virtue of collecting sales and use taxes for a state.[26]

Tax Interaction

The recent tax cut legislation, the "Jobs and Growth Tax Relief Reconciliation Act of 2003" (JGTRRA, P.L. 108-27), included several provisions intended to reduce the federal tax burden on business investment.[27] The federal tax changes also affected state taxes because of the interaction between federal taxes and state taxes on corporations. Generally, states use the federal tax code as the base for the state income tax (see the background section titled "federal starting point"). Thus, when the federal definition of the tax base changes, so does the state definition of income.[28]

JGTRRA included two temporary provisions designed to accelerate the depreciation of capital assets purchased by businesses. The first is a temporary increase in the amount of a capital expenditure that a small business can deduct in the year of purchase.[29] The larger deduction reduces the base of the federal corporate income tax and thus the state corporate income tax base for those states that link directly to the federal tax code. The change in federal law may generate a significant revenue loss in the short run for those states that remain linked to the federal definition of business income.[30] This provision expires on December 31, 2005, which will limit the long run effect (if the provision is not extended).

A second JGTRRA provision allows for "bonus depreciation" for certain capital expenditures. Businesses that buy qualified capital assets before January 1, 2005 can immediately deduct 50% of the purchase price from gross income. The combined effect of the two provisions would cost states an estimated $2.7 billion. If the

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[26] Section 7(a) of S. 1736 states that "[N]othing in this Act shall be construed as subjecting sellers to franchise taxes, income taxes, or licensing requirements of a state or political subdivision thereof, nor shall anything in this Act be construed as affecting the application of such taxes or requirements or enlarging or reducing the authority of any State to impose such taxes or requirements."

[27] For more on the business tax cuts in P.L. 108-27, see CRS Report RL32034, *The Jobs and Growth Tax Relief Reconciliation Act of 2003 and Business Investment*, by Gary Guenther.

[28] Another issue is fiscal policy coordination between the federal, state, and local governments. If state governments do not adopt the federal tax changes, then the fiscal stimulus of federal tax policy is muted by state non-compliance. For more on the countervailing fiscal stimulus effects, see CRS Report RL31936, *General Revenue Sharing: Background and Analysis,* by Steven Maguire, p. 7.

[29] 26 U.S.C. § 179.

[30] According to a recent analysis by the Center on Budget and Policy Priorities, "...17 states stand to lose an estimated $1.1 billion in 2004 and another $600 million by the end of 2005." Nicholas Johnson, "Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years," *Center on Budget and Policy Priorities*, June 5, 2003, p. 5.

provisions were made permanent, the cost to the states has been estimated to rise to $17.7 billion over the 2004-2013 budget window.[31]

Proponents of the accelerated depreciation provisions, however, would argue that over the long run, increased business investment would likely lead to stronger economic growth and in turn *more* corporate income tax revenue. The long run net budget outcome of the two countervailing forces is uncertain and relies on debatable assumptions about the response of businesses to investment incentives delivered through the federal tax code.

The JGTRRA provisions adversely affect state budgets in the short run because the tax relief is delivered through changes in the base. If Congress were concerned primarily with the impact of federal corporate income tax law changes on the states, changes in corporate income tax *rates* would have minimal impact on the states. Unlike changes in the tax base, a federal tax rate change would not directly affect state corporate income taxes.

Current Legislation

Legislation pending in the 108th Congress, H.R. 3184 and its Senate companion S. 1736, would authorize states to compel remote vendors to collect sales and use taxes. Even though these two bills address the collection of state sales and use taxes, not state corporate income taxes, some policymakers believe that the issues are similar to those surrounding the state corporate income tax. H.R. 3220 would establish a "physical presence" standard for business activity taxes (BATs, primarily state corporate income taxes). Following is a brief overview of selected legislation that would affect state corporate income taxes.

H.R. 3184 and S. 1736. Two identical bills (H.R. 3184 and S. 1736), each given the title of the "Streamlined Sales and Use Tax Act (SSUTA)," would authorize states to require out-of-state vendors to collect sales and use taxes. The authority would only be granted once "...10 states comprising at least 20 percent of the total population of States imposing a sales tax ... have petitioned for membership under the Streamlined Sales and Use Tax Agreement...."[32] Businesses with less the $5 million in sales would be exempt from the requirement.[33] And, businesses that collect the tax are to receive "reasonable compensation" from the states for expenses incurred for "administration, collection and remittance of sales and use taxes."[34] The connection to states through the sales and use tax administration has raised concern that implementing the SSUTA would pave the way for states to claim that out-of-state vendors have established nexus. Section 7 of H.R. 3184 (and S. 1736), however, outlines the limitations of the proposed SSUTA. The legislation explicitly states that "No obligation imposed by virtue of the authority granted by section 4

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[31] Nicholas Johnson, "Federal Tax Changes Likely to Cost States Billions of Dollars in Coming Years," *Center on Budget and Policy Priorities*, June 5, 2003, Tables 2 and 3.

[32] Section 4(a).

[33] Section 4(b).

[34] Section 4(c).

shall be considered in determining whether a seller has a nexus with any State for any tax purpose."[35]

H.R. 3220. Under current law, enacted as P.L. 86-272, sales of "tangible personal property" into a state are not sufficient to trigger tax liability. H.R. 3220 would expand the protection beyond tangible personal property to include services.[36] This expansion would have a significant effect on the 32 states where "...an employee's solicitation of services while in the state for six or fewer days would create nexus."[37]

In addition to the expansion of protected interactions, this legislation would also define "physical presence" as the standard for collecting business activity taxes. Under this proposal, physical presence would be established and a business activity tax allowable if:

- the individual or business is physically within the state for 21 days (not including trips to buy goods or services for the business; gathering news for print or other media; meeting with government officials for purposes other than selling goods and services; attending training or educational purposes; or participating in charitable events),

- the individual or business uses the services of another individual or business for 21 days and the hired individual or business does not do business for any other entity, or

- the individual or business leases or owns tangible personal property or real property in the state for more than 21 days.

An important exception to the "21-day rule" is included in the legislation and is related to live performances and sporting events. Generally, the 21-day minimum is replaced with one day for live performances and participation in sporting events where at least 100 spectators are present. There is not a uniform number of days under current state laws, but, most states impose a minimum that is less than 21 days.

Analysis. The streamlined sales tax legislation, H.R. 3184 and S. 1736, would require states to simplify their sales and use tax systems before granting them the authority to compel remote vendors to collect the sales and use tax. From an economic perspective, reduced complexity and compliance costs for businesses, not just those engaged in interstate commerce, would likely increase the efficiency of the tax system. To the extent that the changes imposed by the legislation would treat all transactions neutrally, they would also increase the equity of the tax system.

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[35] Section 7(b).

[36] Section 2 of H.R. 3220 strikes "the sale of tangible personal property," and inserts "a sale" that would presumably include services.

[37] BNA, April 25, 2003.

The critical concern is how stringent the SSUTA enforcement will be if implemented. If the agreement is not strictly enforced, then any gains in economic efficiency are lost and the anticipated improved equity diminished. The de minimus standards, however, could be administratively difficult to enforce and could create loopholes through which businesses could circumvent the intent of the SSUTA. These standards could be eliminated if the SSUTA were strictly enforced and the rules on what was taxable were truly uniform from state to state. The ease of compliance with a truly uniform base would render seemingly arbitrary minimum sales thresholds unnecessary.[38] Even though the statutory burden of the sales and use tax falls on consumers, the SSUTA legislation may be considered in conjunction with other legislation that more directly addresses how states tax businesses.

The BAT legislation, H.R. 3220, is intended to further modify the state taxation of businesses engaged in interstate commerce. The legislation would impose new regulations on how states impose taxes on multi-state businesses, through (1) imposing uniformity on the time component of nexus determination and (2) expanding the definition of goods and services subject to the nexus rules. The legislation would not directly address the complexity of the state corporate income tax structure — in particular, the various apportionment formulas described earlier.

Many economists and other researchers who analyze state corporate income taxes agree that the critical issue with the current state corporate income tax structure is the variability in the allocation and apportionment of corporate income from state to state. The current mosaic of state corporate income tax rules creates economic inefficiencies for the following reasons: (1) relatively high compliance costs, (2) increased opportunities for tax planning by businesses, and (3) potential gaps and overlaps in taxation. The new regulations as proposed in H.R. 3220 could exacerbate underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 also expands the opportunities for tax planning and thus tax avoidance and possibly evasion.

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[38] Charles McClure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004, p. 732.

BUSINESS ACTIVITY TAX

EXAMPLES OF ACTUAL & POTENTIAL AGGRESSIVE STATE ACTIONS AND POSITIONS AGAINST OUT-OF-STATE COMPANIES

ACTUAL CASES

- In Tennessee, the revenue department attempted to tax an out-of-state company engaging in credit card solicitation activities through direct mailings. The department based their authority solely on the presence of the credit cards and the "substantial privilege of carrying on business" in Tennessee. *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). It has been reported that Tennessee, despite having lost this issue in the Tennessee courts, continues to assert this position. In addition, according to a recent survey of top state taxing officials, nineteen other states assert that a business could be subject to tax in the state merely for issuing credit cards to in-state persons. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-36, S-37 (April 23, 2004).

- In Alabama, the revenue department attempted to impose tax on an out-of-state bank because the bank issued credit cards to Alabama persons and leased two MRI machines in Alabama. *Dial Bank v. State of Ala. Dep't of Revenue*, Ala. Dep't of Revenue, A.L.J. Div., Nos. INC. 95–289, F. 95–308 (Aug. 10, 1998).
- A Minnesota law would have declared that a sufficient connection with the state exists when out-of-state health care providers provide care to 20 or more Minnesotans or when they solicit business from potential customers in Minnesota, regardless of whether the health care was provided outside of Minnesota. The Minnesota District Court determined that the tax was unconstitutional as applied to several nonresident health care providers that perform services outside of Minnesota. *See Baertsch v. Minnesota Dep't of Revenue,* Minn. Dist. Ct., 2nd Jud. Dist. No. C7-93–2680 (Minn. Dist. Ct. 1994); *Mercy Medical Center v. Anderson,* Minn. Dist. Ct., 2nd Jud. Dist. No. C4–93–11658 (Minn. Dist. Ct. 1995); and *MeritCare Hospital v. Commissioner of Revenue,* Minn. Dist. Ct., 2nd Jud. Dist. No. C2–94–12818 (Minn. Dist. Ct. 1995).
- *Rylander v. Bandag Licensing Corp.,* 18 S.W.3d 296 (Tex. App. 2000) (Texas could not impose its corporate franchise tax on a business that had merely registered to do business in the state). However, according to a recent survey, four states still take the position that merely registering to do business in a state is a sufficient connection to justify taxation on an out-of-state business. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-10, S-11 (April 23, 2004).

Actual Positions Taken at the Administrative Level

- A small South Carolina software company owned by a husband and wife (annual sales of approximately $100,000) sells software out of their home to customers located in many states throughout the U.S. The software sales include a license agreement between the company and the purchaser. However, the company has no physical presence in any state except South Carolina and Georgia. Recently, New Jersey revenue authorities asserted that the software licenses created sufficient contacts with the state to justify imposing business activity taxes on the company.

Despite the fact that the company's annual revenues from customers in New Jersey over the past few years have been as low as $49, New Jersey's claim against the company would require that the company pay a $500 per year minimum corporate tax and a $100 per year corporate registration fee for as long as its software is being used in the state. One can only imagine the result if each state imposed similar taxes on this mom and pop operation.

- In Louisiana, the revenue department has threatened to assess business activity taxes on several out-of-state companies based on the fact that those companies broadcast programming into the state. The rationale is that these out-of-state companies are exploiting the Louisiana market because the programming is seen and/or heard by individuals in Louisiana.

What the States Publicly Say They Can Do

- The Multistate Tax Commission has endorsed and is actively promoting the adoption of its factor-based nexus proposal (as well as the repeal of P.L. 86–272). Under such standard, a state would be able to impose a business activity tax on any business whose factors exceed certain thresholds; the thresholds are $50,000 in property, $50,000 in payroll, or $500,000 in sales. Under the current physical presence standard, a state may tax companies with property and payroll in a jurisdiction but the MTC would go further by allowing states to tax businesses that only have customers in a jurisdiction. *Ensuring the Equity, Integrity and Viability of Multistate Tax Systems,* Multistate Tax Commission Policy Statement 01–2 (October 17, 2002).

- A recent Oregon regulation takes the position that the presence of intangible property creates a sufficient connection with the state to justify Oregon imposing taxes on out-of- state companies. The regulation would mean that simply maintaining intangible property or receiving franchise fees or royalties from Oregon sources would subject an out-of-state company to taxation, even if services are performed outside of Oregon. Ore. Admin. R. 150–318.020.
- A recent survey shows that eight states take the position that a business whose trucks merely pass through the state six or fewer times in a year—without picking up or delivering goods—have sufficient connections with the state to justify imposing business activity taxes on that company. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-34, S-35 (April 23, 2004).
- According to a recent survey, thirteen states assert that an out-of-state company merely having a website on someone else's server in the state creates a sufficient connection to justify imposing business activity taxes on that out-of-state company. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S- 12, S-13 (April 23, 2004).
- A recent survey of top state taxing officials indicates that twelve states believe that an out-of-state company listing a telephone number in a local phone book located in the state is a sufficient connection with the state to justify taxation. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-10, S- 11 (April 23, 2004).
- A recent survey of top state taxing officials indicates that five states believe that an out- of-state company having a bank account with an in-state bank is sufficient connection with the state to justify taxation. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-36, S-371 (April 23, 2004).
- A recent survey of top state taxing officials indicates that six states believe that an out-of- state company negotiating and/or obtaining a bank loan from an in-state bank is (or could be) a sufficient connection with the state to justify taxation. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-36, S-371 (April 23, 2004).
- Over half of the states in a recent survey stated that they believed that when an out-of- state corporation licenses trademarks to an unrelated entity within the state, the out-of- state company would be subject to taxation by the state. *Special Report: 2004 Survey of State Tax Departments,* 11 Multistate Tax. Rep't 4, pp. S-9 - S-43, at S-36, S-37 (April 23, 2004).

POTENTIAL AGGRESSIVE POSITIONS THAT HAVE BEEN TAKEN IN THE CONTEXT OF OTHER TAXES

- The city of Houston, Texas attempted to impose tax on offshore oil rigs located outside territorial waters or in foreign jurisdictions merely because they were owned by oil companies that were located in the city. The adoption of this approach by states for business activity tax purposes would have significant consequences for the business community and would raise serious constitutional issues. See, *e.g.,* Vincent J. Schodolski, *California county looks to heavens for tax revenue,* Chicago Tribune, July 13, 2001, at 7.
- Certain localities have attempted to impose local personal property taxes on property orbiting in space. For example, the County of Los Angeles, California attempted to impose a property tax on a Hughes Electronics, a county-based company that owned eight communications satellites permanently orbiting in space. Nancy Vogel, *Satellite Tax Idea Is Back to Earth; Finance: The State Board of Equalization adopts a rule forbidding L.A. County levies on the spacecraft. Assessor says he'll study legal options,* Los Angeles Times, July 11, 2001, at 8.

In addition, the city of Virginia Beach, Virginia also attempted to impose local personal property tax on three transponders attached to satellites orbiting in space that were owned by a city-based cable company. *City of Virginia Beach v. International Family Entertainment,* 561 S.E.2d 696 (Va. 2002) (the City of Virginia Beach did not have the authority to impose its tax on the transponders). If states used the same approach to try to impose business activity tax, on the basis that the satellite creates a "physical presence" or because a business generates income in the state by passing over the state, there would be significant consequences for many industries.

- In California, the tax department responsible for sales and use taxes attempted to impose use tax collection obligations on an out-of-state company whose only contacts with California consisted of entering into advertising contracts with California broadcast and cable television companies on the basis that the contracts "converted" the broadcast and cable companies into representatives of the out-of-state business. *JS&A Group, Inc. v. State Board of Equalization,* No. 1075021 (Cal. Ct. App. 1997). The same "logic" could be applied by states to try to impose business activity tax on businesses that merely advertise in a state. JS&A Group, Inc. v. State Board of Equalization, No. 1075021 (Cal. Ct. App. 1997).
- In Florida, the tax department attempted to impose sales tax on an out-of-state business that provided financial news and information using high-speed electronic transmission to a subscriber's video display terminals on the grounds that a sale of tangible personal property occurred because the images were perceptible to the senses. *Department of Revenue v. Quotron Systems,* Inc., 615 So.2d 774 (Fla. Dist. Ct. App. 1993). States could apply similar "logic" to try to impose tax on businesses delivering electronic information into the state.
- In Missouri, the tax department attempted to impose sales tax on an out-of-state restaurant franchisor because it placed orders for equipment on behalf of its Missouri franchisees, even though the franchisor never acquired title to or ownership of the equipment. States could apply similar "logic" to try to impose business activity tax on the out-of-state business. *Doctor's Associates v. Director of Revenue,* Missouri Admin. Hearing Comm'n, No. 95–001748 (Sept. 17, 1997).

May 21, 2004

The Honorable Chris Cannon
U.S. House of Representatives
Chairman, Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
B-353 Rayburn House Office Building
Washington, DC 20515

Re: Business Activity Tax Simplification Act (H.R. 3220)

Dear Chairman Cannon:

The American Bankers Association (ABA) would like to express support for legislation creating a fair, clear, and uniform nexus standard for the imposition of business activity taxes by states and localities. Specifically, we are submitting comments to praise H.R. 3220, the Business Activity Tax Simplification Act and thank you for your leadership in advancing this legislation. The ABA brings together all categories of banking institutions to best represent the interests of a rapidly changing industry. Its membership - which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks - makes ABA the largest banking trade association in the country.

H.R. 3220 would modernize existing law to ensure that states and localities only can impose their business activity taxes in situations where an entity has physical presence (i.e. property or employees) and thereby receives related benefits and protections from the jurisdiction. We agree that a physical presence nexus standard should be preserved in order to ensure an equitable and measurable application of the state tax laws for all industries.

ABA believes that certain clarifications to H.R. 3220 would be helpful in order to establish a fair, clear and uniform nexus standard. In particular, the bill should be revised to ensure that the solicitation of sales also applies to financial services and products. The types of financial services that should be made a part of H.R. 3220 include lending activities and other services such as investment, advisory and custodial services. Moreover, the legislation should be expanded to recognize financial transactions that do not require shipment or delivery. The current legislation covers only orders filled by shipment and delivery. These suggested clarifications recognize the intended scope of H.R. 3220 and encourage business investment.

Thank you for your consideration of our views as you advance this important legislation. We look forward to working with you as you proceed with this bill.

Sincerely,

Edward L. Yingling

May 13, 2004

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

Re: Supporting comments for hearing on H.R. 3220, "The Business Activity Tax Simplification Act of 2003" ("BATSA")

Dear Mr. Chairman Cannon and Mr. Ranking Member Watt:

1We are writing you today to beg for your support for H.R. 3220, "The Business Activity Tax Simplification Act of 2003." We stumbled into this issue last year and have become deeply committed to the passage of this bill. It is no exaggeration when we say this legislation is critical to small businesses everywhere. While we represent no one but ourselves, we are championing this issue because the survival of small business is literally at stake. Without relief, some successful businesses will be forced to close or downsize. The material below provides a snapshot of the legal nightmare that has heavily impacted our business over the past year, and hundreds of other small businesses nationwide as well.

We know first hand that many other companies are impacted because we have talked with dozens of attorneys, small businessmen, and news editors all over the Country about this problem. Unfortunately, many small businesses are not even aware of the problem because they have not been trapped, yet. But, it is only a matter of time before the abuses by aggressive States become widespread and automated record-matching processes jeopardize thousands of additional small businesses with demands similar to those New Jersey is now making upon us.

We are the owners of a *home-based* software development company with actual 2003 sales (not profits!) of slightly less than $100,000. All work is performed in our home, we are the only employees, and our company is our sole source of earned income. Our company is incorporated in Georgia and registered in Georgia and South Carolina. We have elected S Corporation status, operate and pay taxes as such, and file appropriate returns in Georgia and South Carolina each year. We pay employment taxes to South Carolina, and we acknowledge nexus in both Georgia and South Carolina. All work is conducted in South Carolina via the telephone, the Internet, and the U. S. Postal Service.

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

New Jersey acknowledges that its original claim of nexus was based *solely* on the continued use of these seven software licenses within the state. If the licenses did not exist, the remaining $999 by itself would not then have resulted in a claim of nexus. New Jersey's claim of nexus will be made as long as any licenses are in use in the State, even if we cease accepting all business from New Jersey customers and generate zero future income from the State.

New Jersey's claim of nexus generates a requirement for our company to pay $500 per year as the New Jersey *minimum* corporate tax and $100 per year for Corporate Registration fee, *every year*, even in years when we have zero sales in New Jersey and have no other business activity in the State. (If not for the minimum corporate tax and registration fee, *our calculated tax would be less than $1.00 in our best year.)* We have been advised by the New Jersey Department of Taxation that the only way to remove our *future* liability for paying this $600 per year fee is to (1) stop accepting all orders from New Jersey, (2) have zero New Jersey income, (3) terminate all existing software licenses, and (4) have our customers remove all licensed software from their systems. We have been advised that we *cannot* terminate our nexus in future years by abandoning our license agreements and giving clear title of the software to our customers.

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

- We have terminated all of our national advertising. Our sales are down significantly as we attempt to refocus our activity into Georgia and South Carolina only.
- We have stopped accepting all orders from New Jersey locations. *We will accept no business, of any type, from New Jersey locations until small business is given the protection it must have in order to participate in Interstate Commerce on a free and unhindered basis.* In January 2004, we refused to accept a firm order for $15,000 of remote services from a New Jersey customer. Needless to say, that hurt our business badly.
- We have terminated all software licenses in New Jersey, and our customers have removed all licensed software and replaced it with new unlicensed software. As a result, our intellectual property no longer receives the protection it must have in order to insure its viability for future enhancements and improvements and for our future income.

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

Our situation, and that of all small businesses participating in Interstate Commerce, is simply intolerable. Had we sold just one $695 license in 1997 and not derived any further income from *New Jersey customers, we would still be subject to the requirement of paying $600 per year in New Jersey taxes and fees as long as our customers continued to use the licenses. Making the situation even worse, New Jersey has, since we became trapped, expanded its regulations to assert nexus against all companies deriving any type of income from New Jersey customers, regardless of physical presence or de minimis activity.* This latest provision of New Jersey tax regulations includes the sale of tangible products and is in direct defiance of Congressional intent and Public Law 86–272. New Jersey's own Tax Court has ruled that a physical presence is required to assert taxing power; nonetheless, New Jersey's Department of Taxation continues to pursue us. Thus, we are forced to pay thousands of dollars in legal fees to defend ourselves; and we are continually distracted from pursuing the normal business activities which generate all of our earned income.

No company can survive by paying taxes on zero profits. But, in our case, we didn't even have *sales* in three of the six years and only $49.00 in a fourth. Should all 50 states adopt the same provisions as New Jersey, the sale of just one box of paper clips into each state, at any point in time, would generate the requirement to file a state tax return in every state and to pay *$30,000* in minimum taxes and fees per year, forever, even in years when no income is generated in those states, unless a way could be found to terminate nexus. As you can see, New Jersey does not make that easy. Further, no small business can possibly become familiar with the ever-changing and widely varying tax laws of 50 States, nor can it withstand the financial and administrative burdens of preparing and filing 50 separate state tax returns.

New Jersey is not the only State adopting highly aggressive tactics which destroy small businesses. Such tactics are becoming more prevalent each year, and H.R. 3220 would stop the abuses. This legislation is vital for protecting small business through clear codification of existing judicial precedents and adoption of a uniform standard of physical presence for nexus as a specific element of Federal Law.

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

- *Small businesses:* Hopefully, we have adequately conveyed why the passage of H.R. 3220 is absolutely vital for the survival of all small businesses attempting to participate in Interstate Commerce.
- *Large businesses:*Having worked for large business for many years, we understand and support their need for clarity and simplification of the rules which would allow them to devote more attention to delivering products and services instead of defending themselves in legal actions. We realize some States argue that BATSA would encourage use of intangible holding companies to shelter income from State taxation, but there are several easy ways for the States to prevent such abuses by businesses (see "The States" below).
- *The States:*I understand the States are screaming about this bill.
    - (a) Their claim of Federal usurpation of their taxing powers simply does not hold water. Because abuses similar to those we are seeing today occurred during the Colonial period, our Founding Fathers understood that Federal regulation would be vital toward assuring a vibrant economy and wisely gave the Congress broad powers to regulate Interstate Commerce.
    - (b) Their claims of revenue loss are wildly exaggerated in an effort to defeat this badly needed bill. Simplification *always* increases income and profits, thus taxable income will grow. *The distribution of that taxable income may change among the States, but it should.* We do all work from our home; shouldn't we pay all our taxes to South Carolina? Shouldn't this apply equally to large businesses with no physical presence in a State? If a State's revenue drops due to passage of this bill, it is because the State is already engaging in unfair tactics; *and its revenue should and must drop.*
    - (c) We believe the greatest threat to States' revenues is through the improper use of intangible holding companies. If an intangible holding company licenses intangible property to an unrelated company, then it should receive the protection the physical presence standard provides. If the intangible holding company operates only to avoid taxation, without other legitimate business purposes, the States have several remedies they have traditionally employed to prevent any loss of income, and many States have already enacted one or more of them. So, this issue is no reason to avoid prompt passage of this bill.

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

Because physical presence was intended to be the current standard, H.R. 3220 would neither diminish the taxing powers of state and local jurisdictions nor reduce state and local tax revenues. The bill recognizes Congress' responsibility to support a strong U.S. economy by ensuring no undue burdens on Interstate Commerce.

We beg for your support of this bill, on our behalf, on behalf of the thousands of small business owners nationwide whose economic futures rely on it, and on behalf of a strong National economy which also relies on such legislation for its continued and improved strength.

Sincerely,

Bo Horne
Kathy Horne
418 East Waterside Drive
Seneca, SC 29762

May 20, 2004

The Honorable Chris Cannon
Chairman, Subcommittee on Commercial and Administrative Law

Committee on the Judiciary
B-353 Rayburn House Office Building
United States House of Representatives
Washington, DC 20015

Dear Chairman Cannon and Members of the Committee:

On behalf of the American Legislative Exchange Council ("ALEC"), a bipartisan, individual membership organization of over 2,400 state legislators, I thank you for the opportunity to submit this letter for the record for the May 13, 2004 legislative hearing on H.R. 3220, the "Business Activity Tax Simplification Act of 2003."

The purpose of my letter is twofold: to express ALEC's strong support for H.R. 3220, and to specifically rebut a release prepared and distributed at the hearing by the National League of Cities that claimed local governments could lose more than $60 billion annually in revenues from the enactment of H.R. 3220.

First, I need only refer to the testimony of Jamie Van Fossen, Chair of the Iowa House Ways and Means Committee, and public sector chair of ALEC's Tax and Fiscal Policy Task Force. ALEC supports H.R. 3220 because "it promotes federalism, enhances our national economy and thereby increases the financial viability of our state governments, and preserves the constitutional principle of tax competition among the states."

Second, as stated by Representative Van Fossen, H.R. 3220 does not force a choice "between public schools and corporate profits." Opponents of the bill that make this characterization grossly overstate the revenue impact of H.R. 3220 in order to protect overaggressive and unconstitutional imposition of business activity taxes.

A case in point is the $60 billion estimate for local government revenue losses cited in the National League of Cities' release. These sort of numbers, increasingly used by certain state and local government groups, are worse than unhelpful - they deflect consideration from the real issue. To illustrate, a recent study co-authored by University of Tennessee Professor William Fox, a former President of the National Tax Association, estimated that total state and local corporate income taxes in fiscal year 2003 amounted to $34.6 billion. Even with adding other non-income taxes in the study that might be considered business activity taxes, it is hard to reach a number that comes close to the $60 billion loss claimed by the National League of Cities.

What the National League of Cities appears to be asserting is that H.R. 3220 would wipe out all business activity tax revenue at the state and local level nationwide. If the claim is made with respect to local governments only, it is even more absurd. Because the underlying tax principle of H.R. 3220 is to tax businesses where they are physically located, the National League of Cities seems to conclude that all businesses could operate without a physical presence anywhere. This is quite obviously impossible.

Please do not allow unsubstantiated figures like those advanced in the National League of Cities' release to distract the Committee from its important work. H.R. 3220 is of vital importance to the health of our economy and the free flow of commerce between the states.

Thank you for your consideration.

Sincerely,

Duane Parde
Executive Director
American Legislative Exchange Council (ALEC)

MBNA

May 20, 2004

Honorable Chris Cannon
U.S. House of Representatives
Chairman, Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
B-353 Rayburn House Office Building
Washington, DC 20515

Re Hearing on H.R. 3220, Business Activity Tax Simplification Act

Dear Chairman Cannon

I am writing on behalf of MBNA Corporation in support of H.R. 3220, the Business Activity Tax Simplification Act and to thank you for holding a hearing on this important legislation. As you are aware, H.R. 3220 would provide a national jurisdictional standard for the imposition of state and local business activity taxes on interstate commerce. This is a very important issue for MBNA. We look forward to working with you and your committee as H.R. 3220 proceeds through the legislative process.

MBNA is the largest independent credit card issuer in the world. MBNA is also the leading affinity marketing company in the credit card industry and has the endorsement of more than 5,100 organizations. The company maintains its international headquarters in Wilmington, Delaware and has operations throughout the United States and in Canada, Ireland, Spain, and the United Kingdom.

MBNA is greatly concerned about the need to clarify and modernize the nexus rules that govern a financial services institution's obligation to pay business activity taxes to states where the company does not have any property or employees. We think it is clear that it would be unfair for a financial services institution to pay taxes to states that do not provide any benefits or protections to the company. Over the past several years, however, that is exactly what some state and local taxing authorities have sought by asserting so-called "economic nexus" arguments. Essentially, economic nexus would permit states to tax a business that merely had customers in the state but no property or employees. The financial services industry has borne the brunt of such activity, particular credit card issuers. Specifically, some states have asserted that MBNA has nexus in the state merely because residents of that state hold credit cards that have been issued by MBNA – regardless of whether MBNA has any other connection to or presence in the state.

MBNA considers H.R. 3220 to be extremely important legislation. Our goal is to ensure that it provides a definitive resolution to the issue of when states have the authority to impose a tax on out-of-state companies. We agree with the goal of H.R. 3220 to prohibit states and localities from imposing a business activity tax on any entity that does not have a physical presence in the taxing jurisdiction. Businesses would continue to pay business activity taxes to those jurisdictions that provide them with meaningful benefits and protections. In addition, H.R. 3220 would modernize current law (P.L. 86-272) and establish a fair, clear, and uniform nexus standard. Such clarification would, in turn, reestablish the type of stable business climate that encourages increased business investment, expanded interstate commerce, and a healthy American economy.

On behalf of MBNA and its more than 28,000 employees worldwide, we look forward to working with you and your staff to ensure that a bright-line, quantifiable physical presence nexus standard is realized for all industry groups, including the financial services industry. Thank you for your attention to our concerns.

Very truly yours,

James K. Kallstrom
Senior Executive Vice President

May 24, 2004

The Honorable Chris Cannon, Chairman
The Honorable Melvin Watt, Ranking Member
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
United States House of Representatives
Washington, DC 20515

Re: HR 3220-Response to National League of Cities Letter

Dear Chairman Cannon and Ranking Member Watt:

On behalf of the Software Finance and Tax Executives Council (SoFTEC), I write in response to the May 21, 2004 letter sent you by the National League of Cities (NLC) regarding HR 3220, the "Business Activity Tax Simplification Act." The NLC's letter contains inaccuracies and distorts the effect passage of HR 3220 would have on local revenues. SoFTEC asserts that passage of HR 3220 would have no more than a minimal impact on local revenue from business activities taxes.

SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting. Because SoFTEC's member distribute their products to customers in many states and localities but have a physical presence in only a few, it naturally has an interest in ensuring that your Subcommittee has accurate information regarding the effects of HR 3220.

1. Economic Presence Standard:

The NLC, in its letter, asserts that the current business activity tax nexus standard is an "economic presence" standard and that HR 3220 would change the standard to a "physical presence" standard. To the contrary, physical presence is the current nexus standard enforced by the courts and HR 3220 would merely codify it.

There is no reported decision in which a court has ever permitted a state to impose a business activity tax on an out-of-state company that had no more than an economic presence within the state. Each time the courts have sustained such a tax the taxpayer had a physical presence in the taxing state. A fair reading of the most recent cases in this area makes it clear that for a state or locality to impose a business activity tax on out-of-state businesses, there must be a "substantial physical presence" in the state.[1]

NLC's assertion that "economic presence" is the current law is not in accord with the cases. The current state of the law is that a business must have a physical presence in a jurisdiction before that jurisdiction is permitted to impose a tax on its business activities.

2. HR 3220 Would Promote Improper Tax Sheltering:

The NLC claims that HR 3220 would legalize a variety of corporate tax planning techniques that companies use to minimize their state and local tax burden and lead to more "nowhere income" and tax avoidance or evasion. Such claims cannot withstand scrutiny.

A physical presence nexus standard would not prevent states from using their existing arsenal of tools traditionally used to combat illegal tax shelters. The courts are split on whether the intangibles holding company device is an improper tax shelter. However, HR 3220 would have no impact on states' ability to use common law sham transaction and economic substance doctrines to attack such shelters. In addition, such devices are inadequate to shelter income from taxation in states that use combined and unitary reporting and/or "throwback rules." Also, HR 3220 would not prevent states from enacting laws that would deny an income tax deduction for royalties paid to an intangibles holding company.

A company's decision to locate a facility in a low-tax state is not a tax shelter. States often compete with one another for the reputation as a low-tax state. Remote sellers, by virtue of their business model, are able to confine their activities to a smaller number of taxing jurisdictions. The physical presence standard will not allow companies to escape taxes that they currently are legally obligated to pay. Codification of the current physical presence standard merely will clarify for both taxpayers and tax collectors where those tax obligations arise.

State and local efforts to overcome sheltering techniques will not be nullified by HR 3220.

3. HR 3220 Would Disadvantage Local Businesses:

NLC asserts that HR 3220 would place local business including manufacturers at a disadvantage by giving tax breaks to out-of-state business oper-

[1] See *J.C. Penny Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *appeal den.* (Tenn. 2000), cert. den. 531 U.S. 927, 212 S.Ct. 305 (2000); *Rylander v. Bandag Licensing Corporation*, 18 S.W.3d 296 (Tex. App. 2000), Motion for Rehearing Denied March 8, 2001; *9.4 Percent Manufactured Housing Service v. Department of Revenue*, No. Corp. Inc. 95–162 (Ala. Admin. Law Div. Feb.7, 1996); *MeritCare Hospital v. Commissioner of Revenue*, No. C2–94–12818, (D.C. Minn. Sept. 22, 1995); cf, *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15 (1993) (involved a tax shelter).

ating within a state and/or local political subdivision. HR 3220 would not discriminate in favor of out-state businesses.

First, in order for a company to be "operating" in a jurisdiction, it must deploy capital or employees. HR. 3220 would treat all businesses that have property or employees in a jurisdiction equally. A local business with employees or property in the jurisdiction would be treated the same as an out-of-state business with employees or property; the jurisdiction could tax the business activities of both businesses. By the same token, local business could not be taxed by a foreign jurisdiction where the business deployed no employees or property. In this light, HR 3220 actually advantages local business by shielding it from foreign taxing jurisdictions where the local business deploys no capital.

SoFTEC thanks you for the opportunity to provide this response to the NLC's May 21, 2004 letter. If you have any questions, I may be contacted at (202) 331–9633 or mnebergall@softwarefinance.org.

Respectfully submitted,

Mark E. Nebergall
President
Software Finance and Tax Executives Council

June 23, 2004

The Honorable Chris Cannon
House Judiciary Subcommittee on Commercial and Administrative Law
118 Cannon House Office Building
Washington, DC 20515-4403

The Honorable Melvin L. Watt
House Judiciary Subcommittee on Commercial and Administrative Law
2236 Rayburn House Office Building
Washington, DC 20515-3312

Dear Representative Cannon and Representative Watt:

Our organizations collectively represent major segments of North Carolina's economy. In December 2003, we filed a friend-of-the-court brief in a tax case being considered by our state Court of Appeals. (A copy of our brief is attached.)

As our brief states, we are opposed to "state taxing activities that prove hostile to a national common market and the easy flow of commerce within and among the United States. With ever-increasing international competition, states must avoid tax strategies that ultimately discourage transactions between companies in different states. This is particularly true when the transactions involve emerging areas of economic growth such as intangibles."

We urge you to support federal legislation that could address the concerns set forth in our brief.

Respectfully submitted,

NC MANUFACTURERS ASSOCIATION (NCMA)
James M. Bell,
President

NC CITIZENS FOR BUSINESS AND INDUSTRY (NCCBI)
Phillip J. Kirk, Jr.,
President

NC BIOSCIENCES ORGANIZATION (NCBIO)
Samuel M. Taylor,
Executive Vice President

NC ELECTRONICS AND INFORMATION TECHNOLOGIES ASSOCIATION (NCEITA)
Joan P.H. Myers,
President and CEO

No. COA03-1203 TENTH DISTRICT

NORTH CAROLINA COURT OF APPEALS

* *

A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; V. SECRET STORES, INC.;	:	
Petitioners-Appellants,	:	<u>From Wake County</u>
v.	:	
E. NORRIS TOLSON, SECRETARY OF REVENUE, STATE OF NORTH CAROLINA, AND HIS SUCCESSORS,	:	
Respondent-Appellee.	:	

* *

AMICI CURIAE BRIEF ON BEHALF OF THE NORTH CAROLINA MANUFACTURERS ASSOCIATION (NCMA), NORTH CAROLINA CITIZENS FOR BUSINESS AND INDUSTRY (NCCBI), THE NORTH CAROLINA BIOSCIENCES ORGANIZATION (NCBIO), AND THE NORTH CAROLINA ELECTRONICS AND INFORMATION TECHNOLOGIES ASSOCIATION (NCEITA)

* *

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NORTH CAROLINA COURT OF APPEALS

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A&F TRADEMARK, INC.; CACIQUECO, INC.; EXPRESSCO, INC.; LANCO, INC.; LERNCO, INC.; LIMCO INVESTMENTS, INC.; LIMTOO, INC.; STRUCTURECO, INC.; V. SECRET STORES, INC.;	:	
Petitioners-Appellants,	:	From Wake County
v.	:	
E. NORRIS TOLSON, SECRETARY OF REVENUE, STATE OF NORTH CAROLINA, AND HIS SUCCESSORS,	:	
Respondent-Appellee.	:	

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***AMICI CURIAE* BRIEF ON BEHALF OF THE NORTH CAROLINA MANUFACTURERS ASSOCIATION (NCMA), NORTH CAROLINA CITIZENS FOR BUSINESS AND INDUSTRY (NCCBI), THE NORTH CAROLINA BIOSCIENCES ORGANIZATION (NCBIO), AND THE NORTH CAROLINA ELECTRONICS AND INFORMATION TECHNOLOGIES ASSOCIATION (NCEITA)**

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QUESTIONS PRESENTED

I. IS THE ASSESSMENT THE DEPARTMENT OF REVENUE SEEKS TO IMPOSE ON PETITIONERS-APPELLANTS FOR THE 1994 TAXABLE YEAR WITHOUT A STATUTORY BASIS AND THEREFORE IMPERMISSIBLE?

II. HOW DOES THE ASSESSMENT UNDULY BURDEN INTERSTATE COMMERCE AND UNDERCUT NORTH CAROLINA'S ECONOMIC COMPETITIVENESS?

STATEMENT OF THE CASE AND FACTS

Amici adopt Petitioners-Appellants' Statement of the Case and Statement of the Facts. *Amici* would add the following comments based on statements made by the Department of Revenue (DOR) regarding the fiscal implications of this case.[1]

First, a decision in favor of the taxpayers in this case should not cost the State's treasury a dime. This is because this is not a tax refund case. Because this is not a refund case, a decision reversing the judgment below should not require the State to withdraw or appropriate any monies from the General Fund (or elsewhere) to repay taxpayers.

Second, DOR's speculation about the total amount of tax monies the agency theoretically could, in the aggregate, seek from an entire class of business taxpayers (if the agency were empowered to do so by this Court) should have no bearing on the legal questions before this Court. In fact, the case before this Court involves only one tax year (1994) and a contested assessment of less than $2 million.

Third, DOR's claim about the financial "implications" of this case fails to consider the negative consequences its tax pursuit here could have on North Carolina's "business climate".

[1] See, e.g., "Department of Revenue Wins Ruling; Holding Companies Required to Pay" (DOR Press Release Dated 5/22/03). Surprisingly, the Department issued this press release – replete with imperative demands (e.g. "Companies Required to Pay"; "companies ... must pay taxes") – based solely on the trial court's terse order without waiting for appellate review, as if it were a foregone conclusion that this Court would rubberstamp the trial court's order.

A State's approach to taxation, and the predictability of tax liability, play a critical role in corporate decisions about where to stay, expand, or locate. Such decisions, in turn, can have a dramatic impact on state and municipal government revenues.

ARGUMENT

Amici initially urge the Court to consider two overarching points:

1. This is a very important case. DOR has acknowledged that this litigation involves legal issues of broad applicability and that the central question at issue here is one that affects many corporate taxpayers. *Amici* know that the favorability of North Carolina's business climate is also at stake. Conversely, the summary order issued below provides scant evidence as to the case's import.

2. DOR's decision to upset a reasonable interpretation of the tax code is extremely troubling. Companies seek stability and predictability in their financial affairs. With regards to corporate tax liability, North Carolina courts have recognized this basic business need by promising to protect robustly any reasonable interpretation of state law by a taxpayer. As the Supreme Court recently put the time-honored rule: "If a taxin statute is susceptible of two constructions, any uncertainty i

the statute or legislative intent should be resolved in favor of the taxpayer."[2]

In the instant case, companies like the Petitioners-Appellants reviewing the General Statutes to determine their 1994 tax year liability would find no likelihood (much less "certainty") that they were subject to taxation based on the mere licensing of wholly intangible property to entities engaged in in-state business activities. *Amici* submit that North Carolina's economy is becoming increasingly dependent upon intangible property and its licensure, including licensing to in-state businesses. By reversing the assessments, this Court can restore confidence in the predictability of North Carolina's corporate tax statutes (while avoiding serious concerns about their constitutionality in light of Quill and other U.S. Supreme Court decisions),[3] and can, at the same time, avoid risking that out-of-state licensors will curtail or even cease commercial activities with North Carolina companies.

I. THERE IS NO STATUTORY BASIS TO SUSTAIN THE 1994 TAX YEAR ASSESSMENT AT ISSUE HERE

The assessment at issue here involves the 1994 tax year. For that year, the General Statutes offer no suggestion

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[2] Lenox, Inc. v. Tolson, 353 N.C. 659, 664, 548 S.E.2d 513, 517 (2001) (emphasis added).

[3] See, e.g., Michael A. Hannah and C. Wells Hall III, North Carolina Enters The Delaware Intangible Holding Company Fracas, 11 J. of Multistate Tax'n 6 (at p. 3)(July 2001) (noting that "[t]he [DOR] regulation arguably may run afoul of the 'physical presence' standard as set forth in Quill Corp. v. North Dakota").

whatsoever that the corporate income and franchise taxes resulting from "doing business in this State" could be imposed on companies whose only contact with North Carolina is the licensing of an intangible to an in-state business.

Indeed, the history of the "doing business in this State" taxing limitation suggests an opposite rule applies. The phrase first became part of the General Statutes in 1939. In 1956, an opinion issued by the Attorney General stated that a foreign corporation which received royalties for leasing intellectual property to a North Carolina company was "not doing business in North Carolina." Op. N.C. Att'y Gen., [1954-1994 Transfer Binder] N.C. St. Tax Rep. (CCH) ¶ 200-109 (Jan. 11, 1956).

The General Assembly apparently left the phrase "doing business in this State" undisturbed until 2001, when it substantially amended the definition for income tax purposes to encompass "[r]oyalty payments received for the use of trademarks in this State." G.S. § 105-130.7A(a). However, the legislature was unequivocal that the statutory change applied only to tax years long after 1994: "This section is effective only for taxable years beginning on or after January 1, 2001." Session Law 2001-327, Section 1.(f). That non-retroactivity proviso could not be clearer: the legislature intended for the income taxation of foreign trademark licensors <u>only</u> for tax years on or after <u>2001</u>. The statute's effective date offers an ample basis to reverse the decision below. "If the words of a statute are plain and unambiguous, the court need look no further." Westminster Homes, Inc. v. Cary Zoning Bd., 354 N.C. 298, 304, 554 S.E.2d 634, 638 (2001).

However, if the Court does look beyond the statutory language of the 2001 legislation, statements made by a key legislator at a critical juncture in the 2001 General Assembly's consideration of the "doing business" definition make clear that the changes enacted during that session were substantive and dramatic. As the brief of Petitioners-Appellants shows, Rep. Hackney assured his colleagues that language in the bill's title only applied to activities transpiring in tax years "after this point" and "in the future".

That the 2001 legislation contains a non-retroactivity proviso distinguishes this case from other cases where courts have found subsequent legislative amendments to merely clarify preexisting statutory language. For example, in In re: Sales & Use Tax v. Jefferson-Pilot Ins. Co., -- N.C.App. --, -- S.E.2d -- (Slip op. filed 16 December 2003) this Court recently held, in a 2-1 decision, that an amendment to the use tax statute did not enact a substantive change but instead merely was intended to clarify existing law. The amendment at issue in Jefferson-Pilot, however, did not contain a non-retroactivity proviso stating that the amendment could be applied only for prospective tax years.[4]

[4] Moreover, Jefferson-Pilot is also distinguishable because the majority's decision there was based in part on the fact that the legislature said that the amendment was merely effecting

Finally, that G.S. 105-130.7A(a) represented a substantive change to the tax code, as opposed to a mere "confirmation" of existing law, is shown by the report of a high-profile group working contemporaneously with the 2001 session of the legislature. In April 2001, the Governor's Commission on Tax Loopholes and Government Efficiencies issued its Final Report recommending that North Carolina "[f]ollow the Ohio law on related companies and require an[] adjustment for royalty expenses and interest expenses." Governor's Tax Comm'n Report at 3. The rationale for the recommendation, printed below, repudiates any suggestion by DOR that the 2001 legislation was anything less than a substantive, prospective change to North Carolina law:

> "Background: This affects holding companies that have subsidiaries and charge their subsidiaries royalty and interest expenses. Many corporations create holding companies in states that do not tax royalty or interest expenses. These companies charge[] their subsidiaries a royalty and/or interest expense and pay no corporate income tax on the profit. Other states, most notably Ohio and Connecticut, have approved statutes to disallow deductions between their corporate taxpayers and related out-of-state trademark protection companies or other affiliates that manage

"'technical and conforming changes to the revenue laws.'" Slip op. at 4. That is not the case with the 2001 legislation at issue here; the General Assembly did not refer to the 2001 legislation as a mere "technical and conforming change" to the revenue laws. Furthermore, the majority in Jefferson-Pilot noted that the amendment at issue there "merely codified the common law interpretation which had been in effect for nearly a century." Id. Here, however, there is no long-standing "common law interpretation" to support the agency's application of "doing business in this State" to entities such as Petitioners-Appellants, much less one dating back fifty years.

> intangibles. The proposal recommends adoption of the Ohio approach." Id.

Obviously, the use of forward-looking words and phrases such as "proposal", "recommends", "follow" and "adopt[]" contradicts any claim that legislation passed by General Assembly soon thereafter did not create a new statutory taxing standard. And, of course, the report contains no suggestion that the tax DOR seeks to impose for the 1994 taxable year was permitted by the existing laws of the State; indeed, it demonstrates that there was no such statutory authorization – otherwise there would have been little reason for the Tax Commission Report and the 2001 legislation.

In summary, in light of the history of the statutory phrase at issue in this case and the indisputably prospective nature of the 2001 legislation that effected a substantive change to state tax law, a judgment for Petitioners-Appellants should be straightforward -- particularly given the mandate to "resolve any uncertainty in favor of the taxpayer."[5]

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[5] *Amici* note that North Carolina court rulings are legion confirming that proposition our Supreme Court found already "established" more than fifty years ago: "In the interpretation of statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen." Watson Indus., Inc. v. Shaw, 235 N.C. 203, 212, 69 S.E.2d 505, 512 (1952). See also Lenox, 353 N.C. at 666, 548 S.E.2d at 517; Regional Acceptance Corp. v. Powers, 327 N.C. 274, 394 S.E.2d 147 (1990); In re Intermedia Comm., Inc., 144 N.C. 424, 548 S.E.2d 562 (2001). See also, Norman J. Singer, Sutherland on Statutes & Statutory Construction 66.01 (5th ed. 1992) ("[I]t is a settled rule that tax laws are to be strictly construed against the state and in favor of the taxpayer.").

By reversing the judgment below, this Court would vindicate the principle that businesses can rely on reasonable interpretations of our tax statutes, and know that the substantive tax rules will not be changed on them merely based upon administrative whim, but only with the blessing of this State's General Assembly.

II. THE ASSESSMENT BURDENS INTERSTATE COMMERCE AND, PARTICULARLY, NORTH CAROLINA'S ECONOMY

While Petitioners-Appellants' brief thoroughly addresses the serious constitutional concerns raised by the tax assessments upheld below, *amici* also note the useful academic discussion of the constitutional problems caused by unmooring state taxation from such bright-line concepts as "physical presence" and "substantial nexus". See, e.g., Scott D. Smith & Sharlene Amitay, Economic Nexus: An Unworkable Standard for Jurisdiction, 25 St. Tax Notes 787 (Sept. 9, 2002). And this Court has dealt with a range of Commerce Clause issues. See, e.g., Fulton Corp. v. Justus, 110 N.C.App. 493, 430 S.E.2d 494 (1993) (finding state intangibles tax violates the Commerce Clause), rev'd, 338 N.C. 472, 450 S.E.2d 728 (1994), rev'd, 516 U.S. 325, 133 L.Ed.2d 796, 116 S.Ct 848 (1996).

Amici are generally concerned about state taxing activities that prove hostile to a national common market and the easy flow of commerce within and among the United States. With ever-increasing international competition, states must avoid tax strategies that ultimately discourage transactions between companies in different states. This is particularly true when the transactions involve emerging areas of economic growth such as intangibles.

Amici offer below examples of the burdens DOR's taxing theory puts on interstate commerce, particularly that involving North Carolina. In sum, the worrisome effect of DOR's approach is to make it more unattractive for out-of-state entities to have commercial arrangements with North Carolina companies that involve trademarks or other intellectual property.

1. **The Threat to North Carolina Manufacturers**

The North Carolina Manufacturers Association (NCMA) is particularly concerned that the taxing approach upheld below (i.e., the application of DOR's "doing business" Rule found at 17 N.C.A.C. 05C.0102(a)(5)(C), hereinafter, the "Rule") will contribute to out-of-state companies foregoing deals with in-state manufacturers (including deals involving patented manufacturing processes) for fear of assessments by DOR. North Carolina textile companies and other in-state manufacturers are eager to work with owners of intellectual property in need of production services. Yet the DOR taxing approach at issue in this case could discourage such relationships. To take but one example suggested by the Administrative Hearing Officer subsequent to his decision below: When Michael Jordan, or other celebrities, consider textile manufacturers for work printing T-shirts or other logo items, North Carolina companies may lose out to companies without North Carolina nexus. Such missed opportunities will result from out-of-state intellectual property licensors (ones with no "physical presence" in this state) fearing taxation by DOR.[6]

2. **<u>The Threat to North Carolina's Ability to Attract Multi-State Businesses</u>**

North Carolina Citizens for Business and Industry (NCCBI) respectfully impresses upon the Court the extent to which North Carolina's economy is now fueled by multi-state corporations, especially in areas involving intangibles. Should such companies avoid our State as a result of the tax approach deployed here, the detrimental effect could be significant. In addition, NCCBI notes the Administrative Hearing Officer's determination in this case below that "the taxpayers [] acted reasonably and under advice of counsel in interpreting applicable law."[7] Corporate

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[6] <u>See</u> Hannah and Hall, <u>supra</u> note 3, ("[T]he [DOR] regulation, by its terms, may operate to subject to North Carolina taxation an entity that is not otherwise taxable in the state, such as an incorporated, nonresident celebrity who receives royalties from licensing trademarks to unrelated, in-state companies that sell products here."). NCMA is deeply concerned that, if not reversed on statutory or constitutional grounds, the strikingly broad agency tax nexus rule at issue here will be (and has been) applied in a way wholly inconsistent with <u>Quill Corp. v. North Dakota</u>, 504 U.S. 298 (1992), and severely injurious to the State's favorable business climate. Indeed, out-of-state companies who own and license intellectual property could rightly fear that the sale of products incorporating its marks or patents by licensees could bring it within DOR's ambit of alleged taxing authority. It is all too-easy for companies to avoid the issue of DOR's broad claim of taxing authority by focusing their commercial relationships with businesses in other states such as Virginia.

[7] Hannah and Hall, <u>supra</u> note 3, (at p. 2).

taxpayers who act "reasonably" in tax matters should not face assessments where state law is, at best, ambiguous.

3. <u>The Threat to North Carolina's Burgeoning Bio and Information Technology Sectors</u>

The **North Carolina Biosciences Organization (NC BIO)** and the **North Carolina Electronics and Information Technologies Association (NCEITA)** fear that DOR's position here poses a particular threat to the "New Economy" companies North Carolina is so eager to lure, businesses in areas such as bio pharma, electronics, information technology, and telecommunications that rely heavily on intangible "intellectual-property".

The tax assessment in this case is based solely upon DOR's own definition of "doing business in this State," adopted years before the 2001 legislation. Under this regulatory approach to taxation, for income tax purposes, the term is defined as "the owning, renting, or operating of business or income-producing property in North Carolina including, but not limited to . . . [t]rademarks, tradenames, franchise rights, computer programs, copyrights, patented processes, licenses. 17 N.C.A.C. 05C.0102(a)(5)(C).[8]

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[8] It is worth noting that, even if the Rule could lawfully be applied (which *amici* urge that it cannot for the reasons set forth in this brief), the Rule should not be applied to the taxpayer in this case. That is because a remote (out-of-state) licensor, such as the taxpayer in this case, would not be "owning, renting, or operating [intangible] property *in* North Carolina," but would instead be owning, renting or operating that property in and from its own jurisdiction. However, the examples

The burden on interstate commerce, and North Carolina's economy, caused by DOR's approach could be far-reaching. For example, national software vendors considering establishing affiliates in North Carolina may look elsewhere because the intellectual property at the core of such relationships is often governed by license agreements. In addition, DOR's Rule could dissuade companies involved in genetic testing from establishing commercial relationships with companies here.

Finally, consider the hypothetical example of a company called New Bio. The company is based in a state other than North Carolina. Its affiliate, RTPetri, is established as a technology spinoff, and is located in North Carolina. New Bio holds highly valuable, competitively sensitive patent rights in industry-leading organic cell technology. The state it is based in has enacted various laws designed to provide enhanced protection for these types of assets. New Bio has no facilities, assets, employees, or agents in North Carolina.

New Bio licenses its patented technology to RTPetri and other licensee companies, both affiliated and unaffiliated, in exchange for patent royalties that are based upon a percentage of the licensees' sales. New Bio reports all of its income to another state, and pays that state's tax on that income.

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shown *infra* assume, *arguendo*, that the Rule would apply to such out-of-state businesses and activities. In addition, by its plain language, the DOR rule only applies to "income tax". It therefore offers <u>no</u> basis for the agency's imposition of franchise taxes.

RTPetri reports all of its income to North Carolina and pays 6.9% tax on that income. However, because of the license of its technology to a North Carolina customer, under DOR's Rule, New Bio now has a taxable connection not only with its home state, but also with North Carolina: it appears that New Bio must now also pay North Carolina corporate income tax on its purported North Carolina income if it wants to license those patents to a North Carolina licensee, and as long as any North Carolina licensee wishes to receive the benefit of that licensed product.

The same result would apply if New Bio were instead the owner of a patented manufacturing processes. The emerging field of biomanufacturing is heavily dependent on new manufacturing processes that use genetically modified cells to produce new and innovative products. Patented manufacturing processes can also be important in operations such as textile weaving or tobacco processing.

Amici believe that if the DOR Rule at issue here is left undisturbed, New Bio could remain a "hypothetical" company as far as North Carolina is concerned because it will elect to establish commercial relations elsewhere.

CONCLUSION

For the reasons set forth above, *amici* respectfully request that this Court reverse the decision below and disallow the imposition of assessments for the 1994 tax year at issue here.

This the 18th day of December, 2003.

NC MANUFACTURERS ASSOCIATION (NCMA)

NC BIOSCIENCES ORGANIZATION (NCBIO)

NC CITIZENS FOR BUSINESS AND INDUSTRY (NCCBI)

NC ELECTRONICS AND INFORMATION TECHNOLOGIES ASSOCIATION (NCEITA)

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No. COA03-1203 TENTH DISTRICT

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MOTION FOR LEAVE TO FILE *AMICI CURIAE* BRIEF ON BEHALF OF THE NORTH CAROLINA MANUFACTURERS ASSOCIATION (NCMA), NORTH CAROLINA CITIZENS FOR BUSINESS AND INDUSTRY (NCCBI), THE NORTH CAROLINA BIOSCIENCES ORGANIZATION (NC BIO), AND THE NORTH CAROLINA ELECTRONICS AND INFORMATION TECHNOLOGIES ASSOCIATION (NCEITA)

* *

Applicants -- four organizations that collectively represent major segments of North Carolina's economy -- believe that the decision below is erroneous and its reversal key to fostering the State's "business climate". Thus, pursuant to Rule 28(i) of the Rules of Appellate Procedure, we seek leave to file an *amici curiae* brief supporting the position of Petitioners-Appellants.

Rules of Appellate Procedure, we seek leave to file an *amici curiae* brief supporting the position of Petitioners-Appellants.

In support of the motion, we show the Court the following:

1. Applicants' interest in this tax case stems from our knowledge about and concern for North Carolina's economic well-being.

2. **NCMA** traces its roots to an informal association of textile industry leaders begun in 1905. Today, the organization represents the interests of manufacturers, include textile companies and boat builders, across North Carolina. **NCCBI's** mission is to safeguard the State's favorable business climate and counts over 2,200 companies among its members. It was founded in 1943 and serves as North Carolina's Chamber of Commerce. **NCBIO** is a trade organization promoting the development of the biosciences industry in North Carolina. **NCEITA** is a non-profit membership organization dedicated to strengthening the electronics, telecommunications, software, Internet and related service industries in North Carolina.

3. In order to retain and attract good, job-creating companies, North Carolina needs a fair, stable, and predictable business climate. *Amici* believe that the decision below jeopardizes that goal. Moreover, the Department of Revenue (DOR) has acknowledged that this case involves legal issues of broad applicability and its central legal issue affects many corporate taxpayers. Indeed, the Assistant Secretary of Revenue

responsible for the initial administrative decision in this case has written that "a significant number of taxpayers [must] deal with the implications of the Final Decision [i.e. his decision]." Michael A. Hannah and C. Wells Hall III, North Carolina Enters The Delaware Intangible Holding Company Fracas, 11 J. of Multistate Tax'n 6 (July 2001).

4. Applicants' brief would be desirable because, as noted above, the outcome of this case will effect North Carolina's business climate, economy, and many corporate taxpayers; we have unique, first-hand knowledge about all three. In addition, a number of individuals affiliated with applicants are expert in the legal and factual issues central to the case. Our members have, for example, been involved in major state and federal corporate tax cases, and participated during the General Assembly's consideration of business tax statutes.

5. The proposed *amici* brief, which is attached, addresses critical legal questions raised by DOR's effort to impose income and franchise taxes on companies with no physical presence in North Carolina including:

(a) Is there a statutory basis for DOR's action given that the taxable year in question is 1994?

(b) Does such an assessment pose a burden to interstate commerce, particularly commerce involving North Carolina?

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4. As explained in the brief, our position is that:

(a) DOR lacks a sufficient statutory basis for this 1994 fiscal year assessment; and

(b) this case can and should be decided in favor of the Petitioners-Appellants on statutory grounds, but, if it is not, this Court should find DOR's approach does pose an undue burden on interstate commerce.

For the foregoing reasons, applicants believe they satisfy the requirements set forth in Rule 28(i) for leave to file an *amici curiae* brief. Applicants respectfully request that the Court grant this motion, consider the accompanying brief when addressing the case, and, upon considering the merits, reverse the decision below.

STATEMENT OF THE FEDERATION OF TAX ADMINISTRATORS

The Federation of Tax Administrators opposes enactment of H.R. 3220 for the following reasons.

1. There has been no need demonstrated for this violation of principles of federalism.

Whatever impact one assigns to this proposed legislation in terms of revenue or practical effects, there has been no demonstration of a need for this bill by its proponents beyond some light, anecdotal fare. Principles of federalism dictate that the federal government should not encroach on functions of state and local governments so integral to their sovereignty as the powers to tax without a clearly demonstrated need to do so, and no such need has been demonstrated in this instance. Further, the few stories that have been offered purporting to show overreaching by state tax agencies involve only *de minimis* situations - i.e., taxpayers with limited contacts with a state being subjected to that state's taxes - while absolutely no justification has been presented for the bill's protecting from taxation income in the millions of dollars earned in a state that is shifted out of that state into intangible holding companies. By addressing an asserted problem of companies with relatively minor contacts with states being assessed with those states taxes with a bill that would prevent states from taxing the huge amounts of income of multinational corporations indisputably earned within their borders, this bill attempts to swat a fly with a sledgehammer - and does all the corresponding damage that metaphor implies.

Especially in recent years, state and local governments have demonstrated a willingness to work with the business community to develop solutions to problems that have been demonstrated to require Congressional attention. For example, state and local governments worked with the telecommunications industry to produce the Mobile Telecommunications Sourcing Act in 2000, to address the problem of how to determine which taxing jurisdictions should be able to tax wireless telephone calls that can change jurisdictions as they are being made. And, at least partly in response to the U.S. Supreme Court's acknowledgment of a problem with the complexity of state and local sales and use tax regimes in *Quill v. North Dakota*, state and local governments are currently working with many sectors of the business community to simplify the sales and use taxes as part of the Streamlined Sales Tax Project, with an eye toward leveling the playing field for all types of sellers with expanded authority to require tax collection.

Similarly, if the business community were to demonstrate a significant problem, such as complexity in business activity taxes (BAT) or over-aggressiveness on the part of states in imposing such taxes on businesses with only a *de minimis* presence in the state, the state and local governments would be more than willing to work on streamlining those taxes and developing uniform *de minimis* standards. To have one of the states' most integral sovereign functions be compromised as significantly as this bill would compromise the states' ability to tax, requires that the Federation of Tax Administrators object to this bill strenuously.

2. H.R. 3220 does not provide for a physical-presence standard; rather, the standard set by the bill is one of physical presence under certain enumerated circumstances.

Despite how it has been characterized by its proponents, H.R. 3220 does not provide that a state may tax an entity that has a physical presence in the state. Rather, the bill provides that, while a state may not tax an entity that does not have a physical presence in the state, the state may only tax an entity that has one or more of certain types of enumerated physical presences in the state, and that list of circumstances excludes some very substantial carve-outs of a variety of types of physical presence. Some of those carve-outs fall into what has been characterized as a *de minimis* classification - although it might be questionable to consider having an unlimited number of employees in a jurisdiction for three weeks a *de minimis* presence - but there are also complete carve-outs of whole industries or activities, such as purchasing, lobbying and gathering news. So, for example, if this bill became law, a multinational media conglomerate with its headquarters in New York City could build a building in Washington, D.C., and staff it with hundreds of full-time workers, and the District would be prevented from taxing that company.

3. Physical presence is not the current legal standard for BAT nexus.

Without providing a full-blown legal analysis of all of the U.S. Supreme Court's decisions regarding BAT nexus, it is safe to say that the Court has never held that, in order for a state to impose a BAT on a nonresident corporation or similar entity, that entity had to have a physical presence in the state. In fact, there is no need to present an analysis of all relevant Supreme Court cases, because the Supreme Court itself told us just that - twice - in its 1992 decision in *Quill v. North Dakota*, 504 U.S. 298.

In *Quill*, the Court determined that it was going to stay with the standard for Commerce Clause nexus for sales and use tax purposes established in its 1967 decision in *National Bellas Hess, Inc. v. Dept. of Revenue of Illinois*, 386 U.S. 753, in which the Court held that a vendor whose only contacts with the taxing state were by mail or common carrier lacked the substantial nexus required by the Commerce Clause. In *Quill*, the Court referred to this standard, i.e., "the rule that *Bellas Hess* established in the area of sales and use taxes," as a "bright-line, physical-presence requirement."

In *Quill*, the Court was quite explicit in saying that it had never imposed the physical-presence requirement for other taxes, saying so twice: ". . . [W]e have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes . . ." (504 U.S. 314), and,

". . . [I]n our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement . . ." (504 U.S. 315). Thus, it is clear that the U.S. Supreme Court has never ruled that physical presence is the nexus requirement for BAT.

Beyond the lack of U.S. Supreme Court authority for applying the physical-presence requirement to taxes other than sales and use taxes, several state court decisions have required only the lesser standard of economic presence for such other taxes, including, but not limited to: *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).

Therefore, while proponents of H.R. 3220 assert that the bill reflects the current state of the law, it clearly does not.

4. Physical presence should not be the nexus standard for BAT.

Physical presence should not be the nexus standard for BAT for many reasons, including the following:

It encourages tax planning. Especially as it is structured in H.R. 3220, a physical-presence standard encourages corporations to engage in tax planning aimed at shifting income away from a taxing state in which it is earned. For example, a corporation could spin off a holding company to hold its intangibles, such as trademarks and patents, and incorporate that subsidiary in a low-or-no-tax state such as Delaware, and then have that holding company license the use of the trademarks back to the affiliate that operates the stores throughout the states, with the royalties flowing back to the holding company approximating the operating company's income - thereby shifting the income earned where the stores are located, to Delaware (while the operating company takes a deduction for royalties paid, and the holding company loans the funds back to the operating company, with another deduction to the operating company for interest on the loans). H.R. 3220 would prevent a state that was home to the operating stores from assessing the Delaware holding company with tax on the income earned in its state, as South Carolina successfully did in *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993), because the holding company would not have a physical presence in the taxing state, as physical presence is defined in the bill. Ironically, as this example illustrates, while proponents of the bill assert that "businesses should pay tax where they earn income,"[1] this type of tax planning encouraged by H.R. 3220 would have exactly the opposite effect.

Also, while proponents of the bill might dismiss any concern about tax planning that would result from the bill as speculative, it is clear that such planning would occur. First, it is already occurring, as demonstrated by decisions like *Geoffrey* and many others, as well as similar cases in states' administrative pipelines, not to mention situations the states are not aware of. Moreover, while this tax planning might currently be considered risky - and not worth the risk to some corporations who might fear the cost of not having their tax planning upheld by the courts, including the penalties and interest that would be incurred - enactment of this legislation would not only ratify all the current planning that is going on, but also essentially require boards of directors of corporations that are in a position to do so to engage in all levels of such planning that would be made available under this bill, as a matter of their fiduciary duties to their shareholders.

The assertion that an out-of-state seller derives no benefit from a state in which it has no physical presence is "indefensible." A proponent of H.R. 3220 states, "The underlying principle of this legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business."[2] Two noted scholars in the field of state and local taxation responded to a similar statement, and to the "no taxation without representation" argument, as follows:

[1] Statement of Arthur Rosen on H.R. 3220, May 13, 2004, p. 5.
[2] Ibid., p. 3.

> 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.
>
> A second invalid argument relies on the Revolutionary War rallying cry "no taxation without representation." Opponents of tighter nexus rules suggest that those rules would violate the basic American principle that there should be no taxation without representation. That argument fails on several grounds. First, not all rallying cries of the Revolutionary War made their way into the Constitution. An inviolate link between the right to vote and the duty to pay tax is not among those that did. Individuals who lack the right to vote due to nonresidence are nonetheless (properly) taxable. Second, virtually all of the taxes under discussion here are (or would be, under a tighter nexus standard) paid or collected by corporations, not by individuals. Because corporations do not vote, this argument is something of a red herring. Beyond that, out-of- state taxpayers, whether actual or potential and whether corporations or individuals, have the same right to be represented by lobbyists as do in-state corporate and individual taxpayers. Indeed, corporate officials can probably do their own lobbying without running afoul of existing nexus standards, let alone sensible ones. Thus, this charge lacks substance. Third, the same argument could be made against payment of property taxes. Finally, and most fundamentally, the type of taxation that would occur under sensible nexus rules would not discriminate against out-of-state business (something the U.S. Supreme Court would not countenance). Rather, sensible nexus rules would prevent discrimination in favor of out-of-state business by subjecting them to the same rules as in-state businesses, except as required to prevent excessive complexity. Even if it were true that out-of-state businesses had no representation, it is difficult to see the harm in requiring that they pay or collect the same taxes as their in-state competitors. (With uniform taxation, in-state businesses can be expected to help protect the interests of their out-of-state competitors in the political arena, because they will pay the same taxes.)[3]

A physical-presence standard, especially as structured in H.R. 3220, is fundamentally unfair, as it favors out-of-state businesses over in-state businesses, and big businesses over small businesses. H.R. 3220 favors big over small, for, while there is nothing in the bill that specifically limits its protections to bigger businesses, in practical terms, bigger businesses will have more opportunities available to them to engage in the tax-planning activities discussed above. For example, a corporation cannot simply establish an affiliate in a low-tax state and assign all of its income to that affiliate; if that were to happen, the original taxing state could disregard the second corporation as a sham. Instead, there must be at least the guise of a business purpose for setting up that second corporation, and that guise is more available to larger corporations that will, for example, have trademarks to put into another entity and then license back to the original corporations. Mom-and-pop-type operations most likely do not have those options, and likely do not have the resources to pay for the tax-planning services necessary to develop those options.

H.R. 3220 also favors out-of-state businesses over in-state businesses, as illustrated by the banking industry. Banking is an activity that has proven particularly adaptable to the electronic age, with seemingly every service a bank offers - including savings accounts, loans, and investments - able to be conducted without the customer's presence in a bank building. Under H.R. 3220, the smaller local bank with an office in the state will have to pay all of the state's taxes, while the out-of-state bank, which would most likely already be larger and therefore operating with the advantage of a number of economies of scale, will also be free of taxes imposed by

[3]Charles E. McLure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," State Tax Today, March 1, 2004.

the state where it has a substantial customer base - thereby producing a multiple hit on the community, by taking the local bank's customers away while not providing any jobs to the community or paying taxes to the community.

That is another problem with a physical-presence standard: it discourages a business from investing in the communities in which it does business, because the business is motivated to concentrate all of its plant and payroll in tax havens. If, however, the common nexus standard were based on where a business is doing business, i.e., economic presence, a business's decisions about where to locate its property and employees would not be driven by tax considerations, but rather, by market and other economic factors.

5. The current nexus standard is economic presence.

The current standard for sufficient nexus for a state to impose a BAT on an entity operating in interstate commerce under the federal constitution is an economic presence in the state. For example, in its 1944 decision in *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435, 441, the U.S. Supreme Court upheld a Wisconsin dividend tax imposed on nonresident shareholders, stating that personal presence within the state was not essential to the constitutional levy of the tax, and no subsequent decision has held otherwise for purposes of a BAT.

The economic presence standard could take a variety of forms, including, for example, a set amount of property, payroll and/or sales in a state, as has been proposed by both scholars in the field and the Multistate Tax Commission. So, to illustrate, at a certain level of business activity in a state, a multistate bank would be viewed as having a sufficient economic presence in the state to support that state's imposition of its taxes on the bank. Currently, several states have chosen to not impose their BATs to the full extent allowed by the federal constitution, by allowing different levels of economic presence without triggering the imposition of a BAT, which seems to be a healthy illustration of federalism at work.

6. Beyond the general change in the nexus standard for BAT, H.R. 3220 makes other changes to existing law.

H.R. 3220 would negate U.S. Supreme Court decisions upholding attributional nexus through independent contractors, such as *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 107 S.Ct. 2810, a 1987 decision upholding the imposition of Washington's business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor. Section 3(b)(2) of H.R. 3220 prohibits taxation based on the use of a non-employee in the state "to establish or maintain the market in that State," when that non-employee "performs similar functions on behalf of at least one additional business entity during the taxable year." In *Tyler Pipe*, the Court employed the same language used in the bill, when it quoted the lower court for the proposition that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." The intention of this provision to overturn the impact of cases like *Tyler Pipe* is clear; under the bill, so long as an independent contractor was not captive, i.e., it was used by at least two entities, whether related or not, that independent contractor would not supply nexus for any of its employers.

Also, while different numbers of states' tax laws regarding what type of presence in the state constitutes sufficient nexus for imposing their taxes would be overturned in varying degrees, every state with a business activity tax considers the presence of a building in the state sufficient nexus, but H.R. 3220 provides that, for some industries, even the ownership of a building with a permanent staff would not constitute sufficient nexus.

7. The bill's expansion of P.L. 86–272 is unwarranted.

On the one hand, H.R. 3220 purports to establish a physical-presence standard, but, on the other hand, it expands Public Law 86–272 to cover even more activities constituting physical presence than the law covers today. P.L. 86–272 was adopted as a "stop-gap" temporary measure in 1959 to give people time to adjust a Supreme Court decision, but has been allowed to exist well beyond its usefulness, and now is being considered for expansion. An expansion of P.L. 86–272 would contradict both the purported purpose of this bill and the tide of business moving into the electronic age.

8. The bill's carve-outs for particular industries produce outrageous results.

Under Section 3(b)(1)–(3) of H.R. 3220, leasing or owning real property would constitute a taxable physical presence except for such property used for a variety of activities - such as "activities in connection with a possible purchase of goods or services for the business," lobbying and gathering news - so long as the state is not the state of incorporation or commercial domicile. Therefore, a broadcasting network could erect a building in a state, and staff it with numerous full-time employees engaged in "gathering news," and still not be subject to a business activity tax in the state. For all other industries, merely placing employees into a separate employment affiliate could be enough to prevent buildings and factories in the state from creating nexus. Thus, under the bill, simple paper restructurings could easily preempt state taxation, even where the ex-taxpayer maintains large amounts of plant and equipment in the state.

9. The timing of this bill contradicts other activity by Congress.

As noted above, H.R. 3220 not only authorizes and promotes, but could compel for fiduciary reasons, what is now considered risky tax planning that makes use of a variety of means of sheltering income earned in a state. This effect directly contradicts the current activity of Congress in eliminating a variety of tax-shelter activities for federal income tax purposes.

The bill also contradicts Congress's consideration of bills expanding the authority of states to require collection of sales and use taxes by interstate sellers; in that situation, Congress is considering undoing the current physical-presence requirement for purposes of the only taxes for which that standard is required, sales and use taxes, while H.R. 3220 would impose a nexus standard narrower than physical presence on taxes for which the physical-presence standard is not now the law.

Whether or not the bill falls within Congress's powers under the Commerce Clause, this is not an appropriate preemption Congress should be imposing on the states. A state's ability to function is dependent on its ability to fund its operations, and the decisions about how to do that are best made at the state level. States generally oppose the federal government's preemption of their options to tax, but have not done so dogmatically. As noted above, state and local governments have worked with the business community to address the problem of how to source wireless telephone calls, and are currently working closely with the business community to streamline sales and use taxes. In both of those instances, states have worked with the business community to address the problems at hand, and then taken those solutions to Congress for their implementation. In this situation, Congress is considering imposing draconian measures on states where there has not even been a serious problem demonstrated to exist. That is not the role of Congress in our federalist system.

PREPARED STATEMENT OF MULTISTATE TAX COMMISSION

I. INTRODUCTION

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

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

Among the tasks delegated to the Commission is the responsibility to recommend uniform nexus standards for the jurisdiction of states to tax multistate companies. Further, the Compact incorporates the Uniform Division of Income for Tax Purposes which provides specific guidance for how income should be divided among the states. In particular, it establishes a policy standard that the income that is reported to a state should "fairly represent" the business activity in that state. This policy standard is an important benchmark used here to evaluate H.R. 3220.

The Commission was created in 1967 as an effort by states to protect their tax authority in the face of previous proposals to transfer the writing of key features of state tax laws from the state legislatures to Congress. For that reason, the Commission has been a voice for preserving the authority of states to determine their own tax policy within the limits of the U.S. Constitution.

Forty-five States (including the District of Columbia) participate in the Commission, as Compact Members (21), Sovereignty Members (3), Associate Members (18), and Project Members (3).

The Commission is pleased to provide its views on HR 3220, the *Business Activity Tax Simplification Act.*

II. HR 3220 Unravels the Core Principles of Federalism

HR 3220 would have a profound impact on the principles of federalism and the delicate balance in the federal/state relationship. For over 225 years, Congress has recognized the sovereign authority of states to raise revenue. HR 3220 would destroy this core principle and supplant the authority and judgment of state and local elected officials with the judgment of Congress. HR 3220 would result in shifting the entire burden of funding state and local government onto individual state residents and local businesses that, because of their nature, are unable to take advantage of the myriad of tax planning opportunities established in the legislation. Both local and out-of-state businesses impose social costs on state and local infrastructure and it is entirely reasonable for state legislatures to require all businesses to assume a fair share of the cost of supporting those services. As stated earlier, all states currently share this belief and any action by Congress to summarily invalidate the laws of these states would do great damage to our federal system of government.

III. The Current Doing Business Standard vs. Proposed Physical Presence: Sales and Profits Do Matter

Corporate income taxes and other business activity taxes have been based from their beginning on the twin concepts of taxing income based on the taxpayer's residence and on where income is earned-its source. Source taxation taxes economic activity that occurs within a state regardless of how that activity is conducted. State corporate income taxes are imposed generally either on the "privilege of conducting business" in the state or on "income earned" within the state. The Supreme Court has made very clear that sales into a state are one of the prime factors for determining that income is earned in that state. Courts have affirmed the application of these taxes to those who are participating in a state's economy whether through physical presence or the use of intangibles such as ownership of stock, trademarks, patents, and the like, or by selling a product into a state even in the absence of any property (tangible or intangible) or people in the state.

By advocating that companies should be taxed only where they have a physical presence, proponents of this concept suggest that sales are not an integral part of income-producing activities. It is conceptually and factually wrong to suggest that companies can derive income (and thus, profits) without making sales. Without a market or customers, no sales can occur, no income is generated and no profits are made.

With respect to multistate companies, states, with the full support and encouragement of the U.S. Supreme Court, have developed over the last eight decades a functional, fair, and equitable system of attributing income among the states in which such companies do business. That system consists of apportioning income-sharing the tax base-through formulas based on real economic activities engaged in by the company: property, payroll and sales. The Supreme Court has been very protective to insure that states do not discriminate against multistate businesses and has also made sure that state taxes are fairly apportioned.

One important goal of the system of income taxation established by the states is to ensure equal treatment between out-of-state companies doing business in a state and local businesses. Ideally, if an out-of-state company and a local business both earn $100,000 of profits from within a state, that amount of income should be taxed equally by the state. This goal of equity is especially important when the two businesses compete directly with each other for the same customers. Unfortunately, H.R. 3220 would result in a large number of cases where the $100,000 profit earned in a state by the out of state company would become effectively exempt from taxation, while the tax burden would continue to fall on the local business.

H.R. 3220 would disrupt the proper functioning of this long standing state income tax system by allowing companies to artificially shift income away from where a company is earning the income to tax haven locations. H.R. 3220 establishes a system of "headquarters only" taxation that is directly counter to the system of sharing the tax base among the states where real economic activity is occurring. A "headquarters only" system is a colonial concept of taxation that allows companies to earn income and benefit from the services of other jurisdictions, but does not ask them to make a fair payment for the use of those public services.

H.R. 3220 purports merely to simplify tax rules by establishing a bright line nexus standard. This characterization is wrong on many counts. The legislation does not establish a bright line of physical presence but contains many exceptions where even taxpayers that have clear and substantial physical presence would be protected by the legislation from paying tax on the income they earn in a state. Moreover, physical presence is inevitably an unworkable standard as all the litigation that has followed from the *Quill Corp. v. North Dakota* decision has shown. Fundamentally, even remote businesses find they need to have contacts in a state to service their customers or to protect their interests. Businesses use sales representatives in states to increase sales. They hire attorneys to sue customers who have not paid. They send in employees or agents to perform installation or warranty work. The supposed "abuse" cited by the Smithfield Farms witness at the hearing was really an indictment of P.L. 86–272, not of the New Jersey tax agency. The company clearly had a physical presence in New Jersey when it was stopped for tax purposes. The company argued that its activities were limited to those protected by P.L. 86–272, but that could not be determined except after the fact. The dispute in that instant was a precursor to expanded disputes that would occur under H.R. 3220, where a company would for all outward appearances have a physical presence, but would claim that it was exempt under the numerous provisions purportedly defining physical presence. In other words, a bright line physical presence would not necessarily be a physical presence under the bill. How is a tax agency supposed to determine that a physical presence exists? Physical presence can also be hidden and manipulated by less responsible taxpayers in ways that invite abuse. It is not easy for state tax agencies to discover physical presence. Thus, in practice, a physical presence standard leads not to equitable certainty in the application of the law, but to uneven and uncertain tax results: some companies will be discovered and too many others will be hidden.

It is disingenuous to pretend that market states provide nothing to businesses that make sales there. An educated, financially prosperous, secure market is essential for a business to prosper. Recent studies have shown that spending for higher quality schooling adds to the growth rate of Gross Domestic Product (GDP). State and local taxes pay for more than 90 percent of the costs of the education of its citizens. Clearly, this spending provides a direct benefit to companies making sales into a state, because higher incomes generated by educational investments yield higher sales and profits for those companies. Furthermore, states and local governments provide court systems that give remote sellers confidence to sell to consumers in other states knowing they can get recourse in courts in the customers' states and give customers the confidence to buy from remote sellers because the customers know they can get recourse in their own courts against the remote sellers. Finally, state and local governments provide roads and police and fire protection that ensure that the goods purchased from remote sellers will arrive safely.

The argument that companies selling into a state without a physical presence do not receive the benefits of public services from the market state is simply wrong. In analyzing the "no benefits without a physical presence argument," noted tax experts Walter Hellerstein and Charles McLure have stated:

> 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.[2]

H.R. 3220 disrupts source taxation by preempting states from taxing companies that do business in or earn income from within a state, regardless of whether or not they have physical presence. However, even a company with major physical presence in a state can still shift income away from that state. Under HR 3220, a company can create a subsidiary to hold intangibles such as its trademarks that are then licensed to the in-state stores. A company can have a significant number of employees in a state earning income and assign those employees to an out-of-state subsidiary to avoid taxation. A company could even have a building located in a state, but benefit from tax-planning opportunities in the legislation to avoid state taxes. These are just a few examples of physical presence that would be shielded from taxation under HR 3220 that would allow most, if not all, businesses to escape taxation.

HR 3220 would overturn well-developed law in many states which recognizes that a business that utilizes new technologies to exploit a state's market has no less

[2] Charles E. McLure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals, *State Tax Notes*, March 1, 2004.

presence in the state than a local business. Indeed, if presence is measured by sales an out-of-state company may well have a greater presence in a state's economy than a large number of small, local businesses including those with which it directly competes. The legislation would preempt state jurisdiction to tax based on the use of intangible property in a state or sales made into a state. Both out-of-state and local businesses benefit from and impose costs on state services such as education, commercial laws, the state judicial system, and police protections, for which each business should pay its fair share. To exempt remote business from the obligation to contribute to the infrastructures and place the entire burden on local businesses would allow remote businesses to earn significant income in a state without making any contribution toward state services it receives or costs it imposes on a state.

IV. Tax Policy Considerations

a. HR 3220 promotes tax sheltering that would shift the tax burden unfairly to local businesses. HR 3220 is bad tax policy-it is neither simple, efficient or equitable. It would legitimize tax sheltering strategies that some multistate businesses use to shift income artificially out of the state where it was earned to a state or foreign country that does not tax that income.[3] Indeed, it will even require public companies that currently disdain tax sheltering to shift income in this manner because of the fiduciary duty of the company's officers to shareholders to reduce the company's tax liability. The result will be that multistate companies would secure a tax reduction to the disadvantage of purely local businesses. The Congressional Research Service recognized this failing of HR 3220 in its recent analysis stating: "The new regulations as proposed in H.R. 3220 could exacerbate underlying inefficiencies because the threshold for business-the 21-day rule, higher than currently exists in most states-would increase opportunities for tax planning leading to more "nowhere income". In addition, expanding the number of transactions that are covered by P.L. 86–272 also expands the opportunities for tax planning and thus tax avoidance and possible evasion."[4]

b. HR 3220 would have the effect of stifling economic development. HR 3220 creates a number of winners but also many losers in the business world. Some corporations could escape tax liability in every state where it does business except in the state of the corporation's domicile. The result is that more of the tax burden is shifted onto small businesses with few resources and local businesses which will almost certainly reduce-or even eliminate-their ability to compete in the marketplace. Most importantly, HR 3220 could freeze economic development in place as more and more businesses seek to minimize their physical presence in a taxing jurisdiction. If a physical presence standard were established, companies would have a disincentive to move jobs and investments into states where they have customers. Under a physical presence regime, a company making investments in a state into which they market would suddenly face a new business tax liability. Under the existing "doing business" standard, the company should already be paying income taxes to that state. A physical presence standard would have the ironic and highly negative economic effect of inhibiting the free flow of investment across state boundaries.

c. HR 3220 adds complexity to state tax laws and insures years of litigation. Supporters of HR 3220 claim the legislation's physical presence requirement establishes a "bright line" for determining whether a business does or does not have nexus with a state. Certain provisions in the proposed legislation belie this assertion-they are neither a physical presence test nor a bright line test. Rather, HR 3220 contains a myriad of provi-

[3] In plain terms, "tax sheltering" for state tax purposes means here that income is not being reported in proportion to the business activity in the state that gave rise to the income. Instead, the income is being shifted to other locations. Tax sheltering may or may not be technically legal in various instances, but all tax sheltering falls short of the policy standard of the Uniform Division for Tax Purposes Act that income should be reported to states so that it "fairly represents" where the business activity giving rise to that income occurs. Tax sheltering is to be distinguished from legitimate tax planning which involves changing real business activity-the location of jobs, facilities or sales-among states to take advantage of lower tax rates.

[4] Congressional Research Service,"State Corporate Income Taxes: A Description and Analysis", March 23, 2004, p. 14.

sions that would allow businesses to establish a physical presence in a state and yet escape business activity tax liability altogether.

Examples of the inequities created by the legislation abound. The physical presence exception granted to businesses engaged in gathering news and event coverage is illustrative. This provision would allow an out-of-state news organization to locate substantial amounts of real and tangible property and employees in a state yet escape business activity tax liability. This is unfair to in-state taxpayers and also other out-of-state taxpayers who would remain subject to a state's business activity tax solely as the result of engaging in a type of business which would not be protected by HR 3220.

H.R. 3220's requirement that a business be physically present in a state in order to be subject to business activity taxes allows companies to shift income earned in a jurisdiction where they are physically present to a jurisdiction that imposes no business activity tax. A company could set up a subsidiary holding company in a no-tax state, and transfer ownership of its intangible assets-trademarks, patents and the like-to its subsidiary. The subsidiary then licenses the use of such intangibles back to the parent, for which it receives royalties from the parent company. The parent continues to do business in states where it has both a physical presence and sales, but the income earned is shifted out of the state in the form of royalties to the subsidiary holding company.

The interplay between sections of the legislation excepting certain activities in a state from the physical presence rule and those excepting certain kinds of tangible property present in a state is also unfair to businesses that do not participate in such activities, or that own property for different purposes than that allowed by the exception.

For example, the exception to the physical presence rule allowing the presence of employees in a state who meet with government officials for purposes other than selling goods or services permits that out-of-state company to own substantial property as long as that property is used to meet with government officials. A lobbying concern could own retreat facilities, conference facilities or even a condominium for use by the employees when they visit a state to lobby.

The nexus exception pertaining to the presence of tangible property owned by a nonresident company located in a state for purposes of being manufactured, assembled and the like is also unfair to other out-of-state businesses that own similar property that is present in a state for different reasons. A nonresident company could own millions of dollars of property in the form of hazardous materials, machinery components, etc. in a state, which imposes a significant cost to the state in the form of services the state provides, such as police and fire protection. Yet, under this provision, that company escapes paying its fair share of a portion of the service the state renders.

HR 3220 is bad tax policy because it violates a major canon of good tax policy articulated by Adam Smith more than 225 years ago-tax neutrality-taxes should interfere as little as possible with business decisions. H.R. 3220 violates this important principle by influencing the way a business organizes itself and influencing a firm's choice of location. H.R. 3220 subsidizes the activities of out-of-state businesses and shifts a greater burden of taxation onto local businesses and individual taxpayers.

V. HR 3220 Would Overrule Tax Laws in Virtually Every State Based on Economic Activity

HR 3220 would overrule state and local laws currently in effect in virtually every state. HR 3220 applies not only to the corporate income tax, but to other business activity taxes such as public utility gross receipts taxes and gross receipts taxes such as the Washington State Business and Occupations Tax. With a very few exceptions, most states and localities impose at least one business activity tax as a result of economic activity irrespective of whether the company has a physical presence. For example, Maryland imposes its corporate income tax to the full extent allowed by the U.S. Constitution. Nexus exists in New Mexico when a corporation transacts business in or into New Mexico or has a corporate franchise in the state. In South Carolina, every C corporation doing business in the state is subject to the corporate income tax. "Doing business" is defined as the operation of any business enterprise or activity in South Carolina for economic gain. Maryland, South Carolina, and New Mexico have successfully defended their economic presence nexus standard against Commerce Clause challenges in their state court systems; the United States Supreme Court has denied review of the Maryland and South Carolina cases. HR 3220 would statutorily overrule both the state tax statutes in these states and the judicial decisions that have sustained the statutes against constitutional challenge. Congress should respect the considered judgment of state legislatures and courts and not impose such an ill-advised jurisdictional requirement on the states.

VI. Possible Solutions

In context, HR 3220 is an overreaching proposal that seeks to resolve an issue absent consideration of fact, analysis, or current law. While businesses have provided several limited examples of controversy with state revenue departments, revenue commissioners have reported few current instances of taxpayer complaints relating to assessment of business activity taxes. Regardless of the perceived extent of the problem, finding a solution to the problem-if one is needed-is a matter best left to states and businesses themselves.

There is ample recent history of states and businesses working together to find solutions to tax and non-tax issues. In 2001, states, local governments, and the telecommunications industry successfully completed negotiations to formulate sourcing rules for mobile telecommunications services. These rules have now been adopted by more than 30 states and ratified by Congress. Similarly, states, local governments, and businesses are in the midst of a multi-year cooperative effort to modernize, streamline, and simplify state and local sales tax laws as a part of the Streamlined Sales Tax Project. Once completed, this effort will result in administrative cost savings to both sellers and states and provide a mechanism to insure a level playing field among all sellers in the marketplace. Similarly, rulemaking-on tax and non-tax issues—undertaken by states involves substantial input and consultation with the business community.

The sourcing and sales tax projects are examples of specialized, highly technical areas of state tax law that challenged states and businesses in negotiating solutions that resulted in fairness and equity to all parties. Any attempt to revise current state business activity tax laws commands the same consideration. As business operations evolve and recognizing the needs of both states and the business community for continual refinement in the business activity tax area, the Commission has already developed a proposal for consideration. In 2002, the Commission adopted Policy Statement 02-02, which sets forth the Commission's views on the economic presence standard for imposition of business activity taxes. Policy Statement 02-02 also includes the Commission's Factor Presence Nexus Standard for Business Activity Taxes, which bases a company's liability for business activity taxes on a threshold amount of a company's property, payroll, or sales in a state. The Factor Presence Standard is a fair, balanced approach to imposition of business activity taxes that provides equity between in-state and out-of-state businesses while eliminating instances of double taxation or instances where businesses may be assessed tax for minor amounts of presence in a state. This standard would also make it clear, readily apparent and certain to both companies and tax agencies when a company would have nexus with a state-thus producing greater equity and uniformity in the actual application of the tax law to different businesses. In addition, the Commission has offered to initiate discussions between states and businesses, the goal of which would be to find common ground on simple, clear, uniform nexus standard for business activity taxes. Thus far, the business community has been reluctant to engage in these discussions.

Ultimately, a cooperative effort by both states and businesses-one that includes a thorough analysis of current business activity tax nexus statutes as well as controversies that have arisen between businesses and states-is the best method for maintaining viable state tax systems.

We hope this information is helpful to the Subcommittee and its staff during its ongoing consideration of HR 3220. The Commission would welcome the opportunity to answer any questions that Subcommittee Members and staff may have.

Prepared Statement of Martha E. Stark, Commissioner, New York City Department of Finance

Mr. Chairman and members of the Committee, my name is Martha Stark and I am the Commissioner of Finance for the City of New York. On behalf of Mayor Michael R. Bloomberg, I want to express my strong opposition to H.R. 3220, the Business Activity Tax Simplification Act of 2003. This bill would cause New York City to lose as much as $100 million a year in business tax revenue, undermining the fragile economic recovery that New Yorkers, with Washington's help, have worked so hard to achieve.

The keys to New York's thriving business community are safe neighborhoods, well-maintained infrastructure, good schools and other essential services. By adopting a new, restrictive definition of what activities constitute nexus, H.R. 3220 would effectively limit the tax base of state and local governments to resident individuals and to businesses with a high level of physical presence in the jurisdiction beyond the level of contacts required by existing constitutional principles. If H.R. 3220 becomes law, the burden for providing those services through tax revenue would become greater not just for local corporations and mom-and-pop stores, but ultimately for every taxpayer in New York. That, in turn, would encourage those taxpayers either to leave the jurisdiction or resort to increasingly sophisticated tax avoidance schemes. States and the federal government would then have to devote increasing amounts of resources to fighting those schemes. Moreover, by protecting out-of-state businesses from taxation in many jurisdictions, HR 3220 would lead to a substantial increase in the amount of "nowhere" income earned by businesses - i.e., income not taxable by any jurisdiction.

H.R. 3220 is based partly on the premise that taxing authorities are attempting to impose taxes on businesses that have a substantial nexus with the jurisdiction as required by the Constitution, but no physical contacts with the jurisdiction. In fact, this is not widespread and is certainly not the case in New York. Even where a substantial nexus is found to exist, constitutional principles require that the amount of an entity's income allocated to a taxing jurisdiction be proportionate to its activity there, resulting in a small tax liability for firms with only a limited presence in a jurisdiction. New York has actually adopted nexus safe-harbor rules in recent years permitting out-of-state businesses to engage in certain activity in the state, such as attending trade shows or having advertising appear on a server or website belonging to a third party, without incurring tax liabilities.

Taxing jurisdictions are under ever-increasing pressure to attract or retain businesses. One way to do that is to lower the tax burden on traditional "bricks and mortar" businesses by giving greater weight in business income tax apportionment formulas to the location of a business' markets. To the extent those bricks and mortar businesses have markets outside the jurisdiction, their taxes would be lowered. Proponents of so-called market-state sourcing frequently point to the potential higher revenues generated for states where markets are located as offsetting the lost revenue from brick and mortar businesses.

But this offset is only possible if jurisdictions are allowed to broaden the tax base by taxing out-of-state businesses that derive income from the jurisdiction's markets. Legislation such as HR 3220 would move in the opposite direction by making it even harder to tax out-of-state businesses that come into a jurisdiction and derive profits from customers there.

H.R. 3220 is also based on the premise that it simplifies taxation by providing a bright line test. Although multi-state businesses have to contend with the administrative burden of compliance in multiple taxing jurisdictions whose laws are not uniform, H.R. 3220 does not address those concerns by fostering consistency among state and local taxing schemes. It simply enables businesses to conduct a multi-state business tax-free in many jurisdictions. New York City and other jurisdictions have treated businesses without a physical presence very favorably. H.R. 3220 would disrupt the balance that New York City and others have achieved, tipping the scales in favor of businesses that reap substantial financial benefit from New Yorkers but do not physically locate within the City.

Combined reporting - which treats a group of affiliated companies engaged in related economic activities as one taxpayer—is crucial to the ability of taxing jurisdictions to reflect correctly the income earned within their borders by affiliated companies with substantial inter-corporate transactions. Among other things, under H.R. 3220 the combination rules of New York and other combination states could become inoperative with regard to non-nexus corporations.

Equally troubling, H.R. 3220 would allow businesses to engage in significant economic activities within a jurisdiction without triggering nexus. Among these activities are:

- Conducting business through an agent in a taxing jurisdiction as long as the agent acts for at least two principals. The principals and agent can be related and any pricing between them may not be at arm's length. Taxing jurisdictions would be limited to forcing an adjustment to the inter-company prices among the parties;

- The presence in a taxing jurisdiction of the inventory of an out-of-state seller of tangible personal property being manufactured by a third-party contractor; and

Any other profit-making activity conducted for 21 days or less (other than performances or sporting events before audiences of more than 100) regardless of the amount of profit either in absolute terms or in relation to other income of the entity. H.R. 3220 would reverse the progress that has been made to enhance interstate tax fairness through such recent efforts as the Mobile Telecommunications Sourcing Act of 2000 (MTSA). This law was created to provide for the equitable interstate tax treatment of wireless telecommunications services in an era of deregulation. The MTSA recognized the diminishing importance of physical location in the global marketplace. If enacted, H.R. 3220 would prevent New York City and other localities from properly implementing the MTSA.

National projects, such as the Streamlined Sales Tax Project and the MTSA, are the product of government and private sector cooperation. As such, they more effectively address issues of inconsistent taxation of multi-state businesses, while recognizing that the tax burden should be fairly borne by both the bricks and mortar businesses and out-of-state businesses serving the same customer base. In contrast, no state and local taxing authorities were consulted in the development or drafting of H.R. 3220.

H.R. 3220 would have a damaging impact on New York City and other jurisdictions. At a time when the nature of commerce continues to evolve, taxing jurisdictions need the flexibility to modify their laws and rules, as constitutionally allowed, so that they can properly and fairly capture the activity that occurs. Even without this bill, taxing jurisdictions are struggling to keep up with economic developments in order to maintain vital services.

For these reasons, the restrictions imposed by H.R. 3220 are not needed. Moreover, the bill would weaken the ability of taxing jurisdictions to adjust to the growing national trends of Internet and interstate commerce. With more firms conducting business online or in multiple states, we need laws to allow taxing jurisdictions to catch up to business trends, not fall further behind. H.R. 3220 would be a huge step in the wrong direction. I urge this committee to reject H.R. 3220.

Thank you.