

***COALITION FOR
RATIONAL
AND
FAIR
TAXATION***

September 27, 2005

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 20015

Re: Hearing on H.R. 1956, the “Business Activity Tax Simplification Act of 2005”

Dear Chairman Cannon and Ranking Member Watt:

On behalf of the Coalition for Rational and Fair Taxation (“CRAFT”), I would like to thank you for this opportunity to submit this statement for the record for the September 27, 2005 hearing on H.R. 1956, the “Business Activity Tax Simplification Act of 2005.” CRAFT is a diverse coalition of some of America’s major corporations involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and multistate entertainment and service businesses. CRAFT members operate throughout the United States, employing hundreds of thousands of American workers and generating billions of dollars for the nation’s economy.

CRAFT believes that a bright-line, quantifiable physical presence nexus standard is the appropriate standard for state and local taxation of out-of-state businesses and that modernization of Public Law 86-272 is essential for the health and growth of the American economy. Therefore, CRAFT strongly supports H.R. 1956 and respectfully urges the approval of this legislation for consideration by the full Congress and ultimate enactment. CRAFT believes that it is essential for Congress to 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 American economy.

I. BACKGROUND OF THE BUSINESS ACTIVITY NEXUS ISSUE

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 the responsibility for the related national monetary/fiscal system and for foreign affairs). Enacting legislation regarding states and localities imposing, regulating, or removing

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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 and state legislatures 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. Specifically, some state revenue departments have 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 understandable on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state's society. But this country has long stood against such taxation without representation. And worse, the “economic nexus” concept flies in the face of the current state of business activity taxation, which is largely based on the eminently valid notion that a business should only be subject to tax by a state from which the business receives benefits and protections. And worse still, it creates significant uncertainty that has a chilling effect on interstate economic activity, dampening business expansion and job growth. As a practicing attorney, I regularly advise businesses that ultimately decide not to engage in a particular transaction out of concern that they might become subject to tax liability in that state. It is entirely appropriate for Congress to intervene to prevent individual states from erecting such barriers to trade, and to protect and promote the free flow of commerce between the states for the benefit of the American economy.²

Confronted with aggressive – and often constitutionally questionable – efforts of state revenue departments to tax their income when they have little or no presence in the jurisdiction, American businesses are faced with a difficult choice. They can challenge the specific tax imposition – but must bear substantial litigation costs to do so. Or, they can knuckle under to the state revenue departments and pay the asserted tax – but then they risk being subject to multiple taxation and risk violating their fiduciary responsibilities to their shareholders (by paying invalid taxes). 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 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.

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).

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 Congressional Willis Commission report issued in 1965 and more recently by the majority report of the federal Advisory Commission on Electronic Commerce,³ H.R. 1956 is designed to address the issue of when a state should have authority to impose a direct tax on a business that has no or only a minimal connection to the state. This issue has become increasingly pressing as the U.S. and global economies have become less goods-focused and more service-oriented and as the use of modern technology has proliferated throughout the country and the world. H.R. 1956 applies to state and local business activity taxes, which are direct taxes that are imposed on businesses engaged in interstate commerce, such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes. H.R. 1956 does not apply to other taxes, like personal income taxes,⁴ gross premium taxes imposed on insurance companies, or transaction taxes, such as the New Mexico Gross Receipts and Compensating Tax Act and other sales and use taxes.⁵

The underlying principle of this legislation is that states and localities that provide meaningful benefits and protections to a business, like education, roads, fire and police protection, water, sewers, etc., should be the ones who receive the benefit of that business’ taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, H.R. 1956 ensures that the economic burden of state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state. H.R. 1956 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. 1956’s physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners. In fact, creating consistency with the international standards of business taxation is vital to eliminating uncertainty and promoting the growth of the American economy.

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. 1956 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.*

A. *BRIEF HISTORY OF NEXUS BATTLES*

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state is a long-standing issue in constitutional jurisprudence.⁶ In many ways, the issues before the Subcommittee had their birth from a 1959 United States Supreme Court decision. In *Northwestern States Portland Cement*, the Supreme Court ruled that a corporation with several sales people assigned to an office located in the State of Minnesota could be subjected to that state's direct tax scheme.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 cases⁹ (where the taxpayers, who did not maintain offices in the state, conducted activities in the state that were limited to mere solicitation of orders by visiting salespeople), cast some doubt on that "well-settled rule" and fueled significant concern within the business community that the states could tax out-of-state businesses with unfettered authority, thereby imposing significant costs on businesses and harm to the American economy in general. As a result, Congress responded rapidly, enacting Public Law 86-272 a mere six months later. Public Law 86-272 prohibits states and localities from imposing income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state.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

B. *AND IN PRESENT DAY, THE BATTLES WAGE ON. . .*

In the forty-six years after the flurry of activity resulting from the *Northwest Portland Cement* decision, there have been marked transformations in the global economy yet we are no closer to a definitive answer on the question that brings us here today, namely, when may the states impose their business activity taxes on out-of-state businesses. In recent years, certain states and state revenue department organizations have been advocating the position that a state has the right to impose tax on a business that merely has customers there, even if the business has no

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).

physical presence in the state whatsoever.¹² This “economic nexus” theory marks a departure from what businesses and other states have believed (and continue to believe) to be the proper jurisdictional standard for state taxation of business activity taxes. Specifically, CRAFT and other members of the business community believe that a state can impose direct taxes only on businesses that have a physical presence in the state.¹³ The state courts and tribunals have rendered non-uniform decisions on this issue.¹⁴ 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

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: 2005 Survey of State Tax Departments*, 12 Multistate Tax. Rep’t 4, pp. S-4 - S-53, at S-20-S-21 (April 22, 2005). 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).

¹³ The Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary, 108th Cong. (2004) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair Taxation, Jamie Van Fossen, Chair of Iowa House Ways and Means Committee, and Vernon T. Turner, Smithfield Foods, Inc.); Jurisdiction to Tax - Constitutional, Council of State Taxation Policy Statement of 2001-2002; The Internet Tax Fairness Act of 2001: Hearing on H.R. 2526 Before the Subcommittee on Commercial and Administrative Law of the House Comm. on the Judiciary, 107th Cong. (2001) (statements of Arthur R. Rosen on Behalf of the Coalition for Rational and Fair Taxation; Stanley Sokul, Member, Advisory Commission On Electronic Commerce, on Behalf of the Direct Marketing Association and the Internet Tax Fairness Coalition). See also Scott D. Smith and Sharlene E. Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction*, 25 State Tax Notes 787 (Sept. 9, 2002). See also Doug Sheppard, *The Certainty of Disagreement on Business Activity Tax Nexus*, 25 State Tax Notes 420 (Aug. 5, 2002).

¹⁴ See *MBNA America Bank v. State Tax Commissioner*, W.V. Office of Tax App. File No. 510331454001 (Oct. 22, 2004), *rev’d*, No. 04-AA-157 (W.Va. Cir. Ct. June 27, 2005), *appeal pending*; *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Lanco, Inc. v. Director, Division of Taxation*, Superior Court of New Jersey, App. Div., Dkt. No. A-3285-03T1 (Aug. 24, 2005), *rev’g*, 21 N.J. Tax 200 (N.J. Tax Ct. 2003); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. petition filed*, Dkt. No. 04-1625 (June 6, 2005); *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993); *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); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep’t of Revenue Dec. 11, 1995) (*cf. Lanzi v. State of Alabama Department of Revenue*, Ala. Dep’t of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003); 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)).

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 an economic nexus standard argue that the states provide benefits for the welfare of society as a whole and, therefore, the states should be able to collect tax from all U.S. businesses, wherever located. Such an argument is not only ludicrous, but it ignores the fact that businesses (and individuals) are members of the American society and pay federal taxes for such general benefits and protections. 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 and who may someday work for an out-of-state company; apparently, the out-of-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 the education. The absurdity of this position should be clear. Should U.S. companies that have hired people educated in Switzerland have to pay Swiss taxes? 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 out-of-state businesses is truly “taxation without representation.”¹⁸

II. ENDING THE WAR: H.R. 1956

A. PROVISIONS OF H.R. 1956

1. CODIFICATION OF THE PHYSICAL PRESENCE STANDARD

H.R. 1956 provides that, pursuant to the authority granted to Congress under the Commerce Clause, a state or locality may not impose business activity taxes on businesses that do not have a “physical presence” within the taxing jurisdiction. The requisite degree of physical presence

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

¹⁸ Although a business with a physical presence may not vote, it is clearly part of the jurisdiction’s local society and is able to have an impact on the government’s policies and practices

(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 fact that a business used to have (but no longer has) a physical presence in a state is not sufficient grounds for imposing a business activity tax. The 21-day limitation is a quantitative *de minimis* standard, which is both appropriate and consistent with the principle that a person should be subject to tax only to the extent it has received the benefits and protections of a state.

The 21-day limitation 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 for ten days will not have a physical presence in that state. 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. Compliance with and administration of this standard would be 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 physically affect 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. As a result of this provision, H.R. 1956 does not substantially affect current law regarding the taxation of such businesses. 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. 1956 that businesses pay tax where income is actually earned.

For a qualitative *de minimis* standard, H.R. 1956 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 has determined that mere solicitation is qualitatively *de minimis* relative to the benefits of protecting such activities offers to the American economy as a whole.¹⁹ Under H.R. 1956’s qualitative *de minimis* provisions, the

¹⁹ Even the OECD Model Tax Convention, which is benchmark for the international jurisdictional standards for taxation, recognizes that certain activities should be disregarded. Like H.R. 1956, the OECD Model Tax Convention employs a physical presence jurisdiction standard by requiring that, before a source country may impose an income tax on a non-resident business’ commercial profits, the business must have a “permanent establishment” in the source country. The definition of permanent establishment creates a rather high threshold for taxation (much higher than the standard that would be imposed by H.R. 1956). Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, Articles 5, 7 (Jan. 28 2003) (“OECD Model Tax Convention”). Like H.R. 1956, the OECD Model Tax Convention recognizes that there are certain situations that simply do not rise to the level of creating a taxable presence in the state. For example, a “permanent establishment” is not created by the maintenance of either “a stock of goods or merchandise belonging to the enterprise solely for

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). This encompasses visiting current and prospective suppliers, attending (in contrast to hosting) conferences, seminars, or media events, utilizing an in-state manufacturer or processor, or having testing performed in the state. The principle underlying the exclusion of such activities is that the business, in its role as a consumer, is not directly generating any revenue in the state from these activities but, rather, is contributing to the income and economic health of the in-state business (income upon which the in-state business will be taxed by the state). Indeed, from a policy perspective, it makes little sense to impose tax on out-of-state businesses that choose to use the services or purchase products from an in-state company. Doing so creates a disincentive for out-of-state businesses to patronize in-state businesses, thereby negatively impacting the local market and tax revenues. By protecting these activities, H.R. 1956 protects the free flow of interstate commerce. Finally, establishing these protected areas does not create any complexity because each of the areas is quite discrete and clearly defined.

In the area of attributing one business' physical presence in a state to another, H.R. 1956 provides that an out-of-state business will be considered to have a physical presence in a state if that business uses the services of an in-state person, on more than 21 days, to perform services that establish or maintain the putative taxpayer's 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. 1956 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. From a policy perspective or from an economic theory perspective, attribution of nexus between two separate and distinct persons is never appropriate.²⁰ This is because an in-state person conducting activities in a state for an out-of-state person pays tax to that state on its own income – which reflects the amounts paid by the out-of-state person to the in-state person for the value of the activities actually conducted in the state.

the purpose of processing by another enterprise” or “a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise.” OECD Model Tax Convention, Article 5, § 4. The first of these exceptions is comparable to one of the qualitative *de minimis* provisions of H.R. 1956 while the second exception presents a situation that would not even be protected by the provisions of H.R. 1956; H.R. 1956 would, however, protect the activities in the second exception if the out-of-state business did not maintain a fixed place of business in the state. See H.R. 1956, Secs. 3(b)(3)(A) and Secs. 3(b)(1)(A), (B).

²⁰ Attribution of physical presence for business activity tax purposes has been allowed in only one U.S. Supreme Court case where the in-state person performed market enhancement activities and only when those activities were conducted for a single out-of-state person. *Tyler Pipe Industries Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232 (1987).

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 U.S. business that contracts with a Taiwanese manufacturer to make products to be sold in the United States. 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.

2. MODERNIZATION OF PUBLIC LAW 86-272

As mentioned earlier, the economy has undergone significant changes since Public Law 86-272 was enacted in 1959. In addition to codifying the physical presence nexus standard, the H.R. 1956 modernizes the longstanding protections of Public Law 86-272 to include *all* sales and transactions, not just sales of tangible personal property.²¹ These provisions bring Public Law 86-272 into the 21st century by recognizing the shift in the focus of the global economy from goods to services and the increased importance of intellectual property.

H.R. 1956 also ensures that Public Law 86-272 covers *all* business activity taxes, not just net income taxes. This modernization provision addresses the efforts of some aggressive states to avoid the restrictions on state taxing jurisdiction as legislated 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 are the Ohio Commercial Activity Tax (“CAT”), which was enacted effective July 1, 2005 to impose a gross receipts tax and the New Jersey Corporation Business Tax, which was amended effective in 2002 to impose a gross profits/gross receipts tax.²² What is most distressing about the New Jersey amendments is that, after June 2006, these

²¹ It is important to note that the business activity tax nexus provisions of H.R. 1956 and Public Law 86-272 are two separate constraints on state taxation of interstate commerce. Each law operates independently of the other. Thus, any activities protected by Public Law 86-272 as modernized by H.R. 1956 will not create a physical presence for that business, regardless of whether the protected activities occur in the taxing jurisdiction on more than 21 days.

²² Other examples are the Michigan Single Business Tax and the taxable capital portion of the Texas corporate franchise tax. See *Gillette Co. v. Michigan Dep't of Treas.*, 497 N.W.2d 595 (Mich. Ct. App. 1993) and *Guardian Indus. Corp. v. Michigan Dep't of Treas.*, 499 N.W.2d 349 (Mich. Ct. App. 1993) (P.L. 86-272 does *not* apply to the SBT because the SBT is not a net income tax but a tax on the privilege of a company to conduct business activities in the Michigan) and *INOVA Diagnostics, Inc. v. Strayhorn*, No. 03-04-00503-CV (Tex. Ct. App. May

“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. While other states have not yet enacted such a targeted end-run around Public Law 86-272 as New Jersey, the enactment of the Ohio CAT is an indication that states are increasingly considering enacting non-income-based business activity taxes.²³

B. *COMPARISON TO CURRENT COMMON LAW*

The physical presence nexus standard in H.R. 1956 is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Due Process Clause and the Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a “substantial nexus” between the taxing state and the putative taxpayer, whereas the Due Process Clause requires only a “minimum” connection. In *Quill*, the Supreme Court determined that, in the context of a business collecting sales and use taxes from its customers, the substantial nexus requirement could be satisfied only by the taxpayer having a non *de minimis* physical presence in the state; the Court refrained from articulating the appropriate measure for business activity taxes.²⁴ This is because under the American legal system, a court only has the authority and responsibility to address the case before it. The Supreme Court has not granted a writ of *certiorari* to a case that would permit it to address the business activity tax nexus issue. So what constitutes substantial nexus for business activity taxes?²⁵

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

26, 2005) (Public Law 86-272 exempts earned surplus from taxation but the taxpayer remained subject to the net taxable capital portion of the Texas corporate franchise tax).

²³ Another example is the 2003 budget proposal by Kentucky’s Governor Paul Patton that would have replaced 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. See *Securing Kentucky’s Future*, State of Kentucky, Office of the State Budget Director (January 2003). The Kentucky legislature ultimately did not adopt Governor Patton’s budget.

²⁴ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

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

of direct taxes such as business activity taxes. Indeed, the standard for business activity taxes should, if anything, be *higher* than the standard for sales taxes for at least two reasons. First, a business activity tax is an actual direct tax, and not a mere obligation to collect tax from someone else, so if anything, the consequent greater economic burden should require a greater connection with the taxing state (as the Supreme Court *seems* to have recognized).²⁶ Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes.²⁷ 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 lower standard for business activity taxes than for sales and use taxes.²⁸ Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.

III. OTHER CONSIDERATIONS

A. FEDERALISM

Contrary to the arguments of some opponents of clarifying the standards for state business activity taxes,²⁹ considerations of federalism support passing this legislation. A fundamental aspect of American federalism is that Congress is given the authority and responsibility to ensure

²⁶ “As an original matter, it might have been possible to distinguish between jurisdiction to tax and jurisdiction to compel collection of taxes as agent for the State, but we have rejected that.” *Quill Corp. v. North Dakota*, 504 U.S. 298, 319 (U.S. 1992) (Scalia, J., concurring in part and concurring in the judgment) (citing *National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977); *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960)). See also *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (1977) (“Other fairly apportioned, non-discriminatory direct taxes have also been sustained when the taxes have been shown to be fairly related to the services provided the out-of-state seller by the taxing State. . . . The case for the validity of the imposition upon the out-of-state seller enjoying such services of a duty to collect a use tax is even stronger.” (citations omitted)).

²⁷ See, e.g., *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (U.S. 1977).

²⁸ This includes *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *America Online v. Johnson*, No. 97-3786-III, Tenn. Chancery Ct. (Mar. 13, 2001); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep’t of Revenue Dec. 11, 1995), *reh’g denied*, 1996 Ala. Tax LEXIS 17 (Ala Dep’t of Revenue Jan. 29, 1996) (*But see Lanzi v. State of Alabama Department of Revenue*, Ala. Dep’t of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003)).

²⁹ See, e.g., *Federalism at Risk: A Report by the Multistate Tax Commission*, Multistate Tax Commission (June 2003); *Respecting Federalism*, Multistate Tax Commission Policy Statement 03-01. Interestingly, some of these same critics of H.R. 1956 recognize Congress’s authority to legislate in the area of multistate taxation. For example, the National Governor’s Association (“NGA”) is currently supporting Congressional intervention in the multistate tax arena in two instances. The first involves the NGA’s efforts to encourage Congress to enact legislation that would override *Quill*’s physical presence requirement for sales and use taxation collection obligations. (Like H.R. 1956, such legislation addresses *when* a state can require a business to collect sales and use taxes and not *how* a state may define its sales and use tax base.) The second is the NGA’s support of S. 1066, the “Economic Development Act of 2005,” which would permit states to provide tax incentives for economic development purposes (thereby overriding the decision of the United States Court of Appeals for the Sixth Circuit in *Cuno v. DaimlerChrysler*). The NGA and other supporters of these two legislative measures cannot fairly invoke the federalism argument to oppose H.R. 1956 while failing to embrace the same principle in support for Congressional intervention to override judicial decisions affecting other matters of multistate taxation.

that interstate commerce is not burdened by state actions (including taxation of such commerce).³⁰ 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.³¹ Some critics argue that such measures are too restrictive and violate principles of federalism.³² No one disagrees that tension exists between a state's authority to tax and the authority of Congress to regulate interstate commerce. However, the very adoption of the Constitution was itself a backlash against the ability of states to impede commerce between the states; in adopting the Constitution, which expressly grants Congress the authority to regulate interstate commerce, the states relinquished a portion of their sovereignty.³³ Moreover, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.³⁴

H.R. 1956 simply codifies the traditional jurisdictional standards for when a state or local government may impose a tax on a business engaged in interstate commerce; the bill does nothing to determine how a state may tax businesses that are properly subject to its taxing jurisdiction. A state remains free to determine what type of tax to impose, 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

³⁰ 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).

³¹ A few other examples include the Federal Aviation Act, which prohibits states and localities from levying a ticket tax, head charge, or gross receipts tax on individuals traveling by air, provides that airline employees may be taxed only in their state of residence and the state in which they perform at least fifty percent of their duties, allows only states in which an aircraft takes off or lands to tax the aircraft or an activity or service on the aircraft, and prohibits state "flyover" taxes; the Mobile Telecommunications Sourcing Act, which prohibits states from taxing mobile telecommunications service unless the state is the user's place of primary use of the service; the Amtrak Reauthorization Act of 1997, which prohibits states from taxing Amtrak ticket sales or gross receipts; Public Law 104-95, which prohibits states from taxing pension income unless the pensioner resides in that state; the ICC Termination Act of 1995, which prohibits states from taxing interstate bus tickets; the Miscellaneous Revenue Act of 1981, which prohibits states and localities from imposing property taxes on air carriers' property at a higher rate than that which is imposed on other commercial or industrial property in the state; the Railroad Regulatory Reform and Revitalization Act of 1976 (the "4R Act"), which prohibits states from imposing differing taxes on railroad property; and the Soldiers and Sailors Civil Relief Act of 1940, which limits state taxation of members of the Armed Forces to the member's state of residence, prohibiting different states in which the member may be stationed from also taxing that member. For a detailed list of instances where Congress has exercised its authority under the Commerce Clause, see Frank Shafroth, *The Road Since Philadelphia*, 30 State Tax Notes 155 (October 13, 2003).

³² See *Federalism at Risk: A Report by the Multistate Tax Commission*, Multistate Tax Commission (June 2003); *Respecting Federalism*, Multistate Tax Commission Policy Statement 03-01.

³³ 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).

³⁴ *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.").

and/or sales; to set the rate at which the chosen tax 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. H.R. 1956 merely confirms that the ability of states to tax is subject to constitutional limitations. Thus, H.R. 1956 strikes the correct balance between state autonomy/sovereignty and interstate commerce.

The economic nexus standard asserts that a business is subject to and liable for 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 free market economy benefits from the purchase-sale 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 commerce, thereby putting up trade barriers to free trade.³⁵ This led to some states retaliating by banning products from other states. By effectively imposing such toll charges, the economic nexus standard will clearly have a negative impact on interstate commerce.

B. *EFFECT ON INTERNATIONAL TAXATION AND AMERICAN COMPETITIVENESS*

Our country's own history and the federal government's position in the context of international taxation provide 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 global principle and has been extremely important to U.S. businesses and, thus, to the American 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.³⁶ 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

³⁵ See, *e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 11 (1824); *Quill v. North Dakota*, 504 U.S. 298, 313 (1992).

³⁶ United States Model Income Tax Convention of September 20, 1996, Art. 5.

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.³⁷ 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 to that country. There is no doubt that the United States government and business community would be outraged and that the American economy would be dramatically injured. 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 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 American economy. Enactment of H.R. 1956, 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.

C. *INTERPLAY WITH STATE TAX INCENTIVES*

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 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.

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 of the state. Not only does this offend the basic principle of

³⁷ The expanded Commentary on permanent establishments, which is expected to be finalized this year states:

Indeed, the fact that a company’s own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

In short, the OECD working group determined that a company does not have a permanent establishment in a foreign jurisdiction merely because that company receives an economic benefit from a foreign company does not mean that the foreign company constitutes a permanent establishment. This is consistent with the qualitative *de minimis* standards of H.R. 1956. 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).

nondiscrimination that is required by the Commerce Clause of the U.S. Constitution,³⁸ 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.

D. EFFECT ON AMERICAN JOB RETENTION AND GROWTH

The American 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 American 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. 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 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

³⁸ 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).

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. 1956 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. 1956, 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.

IV. CROSSING SWORDS: RESPONSE TO REVENUE & TAX PLANNING “ATTACKS”

A. EFFECT ON STATE REVENUES

There simply is no basis for the assertion that H.R. 1956 could lead to any meaningful loss of state revenues, much less the \$10 billion revenue loss of that has been bandied about by state tax officials and organizations.³⁹ H.R. 1956 does not depart to any significant degree from what is now being done in the states. This has been confirmed by the former executive director of the Multistate Tax Commission.⁴⁰ A physical presence standard merely ensures that businesses are taxed only by those states that provide benefits and protections (*i.e.*, by those states in which businesses have property or employees). Outside the context of passive investment companies,⁴¹ which have been characterized as “tax shelters” by many state officials, 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. 1956 would have no effect on taxes derived from businesses that maintain a facility or inventory 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

³⁹ Dolores W. Gregory, *New MTC Chief Names Top State Issues: SSTP, BAT Bills and Federal Tax Reform*, 179 DTR G-8 (2005) (“The BAT proposal would create a physical presence standard for states to impose income and other business activity taxes on interstate commerce. If it is enacted as written, states stand to lose between \$7 billion and \$10 billion from various carve-outs in the legislation, Huddleston said.”)

⁴⁰ “It seems to me that the states need to face the reality that most of them are generally incapable of enforcing the ‘doing business’ standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway.” Eugene F. Corrigan, *States Should Consider Trade-Off on Remote-Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

⁴¹ 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).

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 who 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. And while the modernization of Public Law 86-272 will extend to businesses soliciting sales of services and other types of property that are currently subject to tax in a state, the amount of tax that is actually being collected by that state is likely minimal. This is because most state apportionment formulas apportion receipts from services based on “cost of performance,” which will likely mean that the virtually all of the business’ receipts are sourced outside of the state (*i.e.*, where the services are performed and the properly and all operating and management employees are located).

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 current 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 the 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, surely must be minimal because it is unlikely that businesses are paying business activity tax to states in which they only have a fleeting presence (in any event, the apportionment percentage would necessarily be quite small). It is essential to keep in mind that H.R. 1956 is based on the principle that a business engaged in interstate commerce should pay its fair share of tax.⁴² H.R. 1956 does not *seek* to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the appropriate jurisdiction.

One of the difficulties that the business community has with the revenue estimates is that there is little empirical data showing where such extensive revenue losses would come from. With respect to charges that H.R. 1956 as currently drafted, it is interesting to note that the critics have charged that H.R. 1956 would cause up \$10 billion in revenue loss “from various carve-outs in the legislation.”⁴³ As explained below, the basis for any assertions appear based on flawed interpretations of the provisions of the legislation, and wrapped up in tax sheltering accusations

⁴² 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).

⁴³ Dolores W. Gregory, *New MTC Chief Names Top State Issues: SSTP, BAT Bills and Federal Tax Reform*, 179 *DTR G-8* (2005).

to add political “heat.”⁴⁴ Bear in mind that 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).⁴⁵ Such considerations do not make for a reliable or accurate revenue estimate because: (1) revenue impact analysis should be formed based on what is currently occurring, not on what could potentially occur,⁴⁶ and (2) because of the physical presence standard, a business would have to engage in a physical relocation, not just a paper restructuring, and there is no evidence that businesses engage in unworkable restructurings simply to avoid paying state taxes.

B. *NOT A TAX SHELTER VEHICLE*

H.R. 1956 neither encourages the use of abusive tax planning nor nullifies the ability of states to attack such shelters. Under H.R. 1956’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

⁴⁴ 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.”

⁴⁵ *See, e.g.,* the debunking of the report of the California Franchise Tax Board concerning H.R. 1956. *Response to California Franchise Tax Board Analysis of H.R. 1956: 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).

⁴⁶ During the 107th Congress, the Multistate Tax Commission asserted that H.R. 2526 caused \$9 billion of *potential* revenue loss per year. *See, e.g., 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 June Summers Hass, Commissioner of Revenue, Michigan Department of Treasury). However, neither the mere potential to collect tax nor the potential revenue loss resulting from possible tax planning are factors in determining revenue impact; revenue impact is based on the actual amounts that are currently collected.

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.⁴⁷ At any rate, if any business were to relocate, it would be required to pay taxes to the jurisdiction to which it moved.

Perhaps most important, H.R. 1956 would have **no** effect on the ability of states to attack tax shelters using weapons such as the common law principles of economic substance, alter ego, and non-tax business purpose or statutory remedies such as combined reporting (which is used by many states, including Kansas), I.R.C. § 482-type authority to make adjustments to properly reflect income, statutory addbacks (which are being enacted by an increasing number of states, e.g., Georgia and North Carolina), or similar provisions. 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.

V. CONCLUSION

The physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy⁴⁸ 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.⁴⁹ 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. H.R. 1956 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.⁵⁰

⁴⁷ 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).

⁴⁸ 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.

⁴⁹ 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).

⁵⁰ While it is unrealistic that H.R. 1956 will end all controversies concerning the state tax business activity tax nexus, any statute that adds nationwide clarification obviously reduces the amount of controversy and litigation by narrowing the areas of dispute. For example, in the forty-six years since its enactment, Public Law 86-272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense.

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On the other hand, our country's own history and the federal government's position in the context of international taxation provide sufficient reason to avoid an economic nexus standard. If a foreign country tried to tax the profits of U.S. companies simply because the U.S. firms exported goods to that country, the U.S. government and business community would be outraged. It is precisely for this reason that U.S. income tax treaties provide the nexus concept of "permanent establishment." A physical presence standard places an appropriate limit on states gaining taxation powers over out-of-state firms and conforms to common sense notions of fair play.

What the entire nexus issue boils down to is fairness. The bright-line physical presence nexus standard of H.R. 1956 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 these reasons, the bill would benefit both U.S. businesses and consumers and, thus, the American economy as a whole.

Unlike other state tax issues currently the subject to debate, at this time, there is no indication that the business activity tax nexus issue will be settled absent Congressional action. The comments herein only scratch the surface of why a physical presence nexus standard for business activity taxes and modernization of Public Law 86-272 is the right answer and why H.R. 1956 should therefore be enacted. But it is clear that H.R. 1956 warrants the full and enthusiastic support of the Subcommittee. H.R. 1956 will not cause any meaningful dislocations in any state's revenue sources and will not encourage mass tax sheltering activities. Instead, its enactment will ensure that the U.S. business community, and thus the American economy, are not unduly burdened by unfair attempts at taxation without representation.

Sincerely,

Arthur R. Rosen
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