

The Business Activity Tax Simplification Act
Questions and Answers

1. *What does BATSA seek to accomplish?*

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,¹ BATSA addresses 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.

2. *On what taxes does BATSA focus?*

BATSA applies to state and local business activity taxes, which are direct taxes that are imposed on businesses engaged in interstate commerce, such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes. BATSA does not apply to other taxes, such as personal income taxes,² 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.³

3. *What is the basis for BATSA's business activity tax nexus provisions?*

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 to 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, BATSA ensures that the economic burden of state tax impositions are appropriately borne only by those businesses that receive such benefits and protections from the taxing state.

4. *What is the background of the business activity tax nexus issue that BATSA addresses?*

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state is a longstanding issue in constitutional jurisprudence.⁴ Some of the issues involved in answering this question stem from a 1959 United States Supreme Court decision. In *Northwestern States Portland Cement*, the Supreme Court ruled that a corporation with several

¹ 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.

² In addition, nothing in BATSA affects the responsibilities of an employer to withhold personal income taxes paid to resident and nonresident employees earning income in a state or to pay employment or unemployment taxes.

³ N.M. STAT. § 7-9-1 *et seq.*

⁴ See, e.g., Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 Tax Law. 37 (1987).

sales people assigned to an office located in the State of Minnesota could be subjected to that state's direct tax scheme.⁵ 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."⁶ The Supreme Court's 1959 decision in *Northwestern States Portland Cement*, coupled with the Court's refusal to hear two other cases⁷ (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 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.⁸ Subsequently, the Congressional Willis Commission studied this and other interstate tax issues and concluded that, among other things, businesses should not be subject to direct taxes where business merely have customers but no physical presence.⁹

In the forty-six years after the flurry of activity resulting from the *Northwest States Portland Cement* decision, there have been marked transformations in the global economy yet we are not closer to a definitive answer on the question of when may the states impose their business activity taxes on out-of-state businesses. In recent years, certain states and state revenue departments have advanced the position that a state has the right to tax a business that merely has customers in the state, even if the business has no physical presence in the state whatsoever.¹⁰ This "economic nexus" approach 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, members of the business community believe that a state can

⁵ *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

⁶ *Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).

⁷ *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).

⁸ P.L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).

⁹ 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).

¹⁰ 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).

impose direct taxes only on those businesses that have a physical presence in the state.¹¹ The state courts and tribunals have rendered non-uniform decisions on this issue¹² but the Supreme Court has not granted writs of *certiorari* in relevant cases.¹³

5. How does BATSA resolve the business activity tax nexus issue?

BATSA 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 (employees, property, or the use of third parties to perform certain activities) is set at greater than 14 days during a taxable year, with presence in a state to conduct limited or transient business activity 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 14-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 in a state only to the extent that the person has received benefits and protections from that state.

For a qualitative *de minimis* standard, BATSA 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

¹¹ *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).

¹² See, e.g., *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 U.S. LEXIS 6033 (2005); *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert. denied*, 2007 U.S. LEXIS 7736 (2007); *West Virginia Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert. denied*, 2007 U.S. LEXIS 7868 (2007); *Acme Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72 (Mo. 2002); *Rylander v. Bandag Licensing Corp.*, Tex. App. Ct., No. 03-99-004217-CV (May 11, 2000); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *app. denied* (Tenn. 2000), *cert. denied*, 531 U.S. 927 (2000); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep’t of Revenue Dec. 11, 1995) (*cf. Lanzi v. State of Alabama Department of Revenue*, Ala. Dep’t of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003)); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

¹³ *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 U.S. LEXIS 6033 (2005); *Comptroller of the Treasury v. SYL, Inc.*; *Crown Cork & Seal Co. (Del.), Inc.*, 825 A.2d 399 (Md. 2003), *cert. denied*, 540 U.S. 9 and 540 U.S. 1090 (2003); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *Geoffrey, Inc. v. South Carolina Tax Comm’n*, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993); *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert. denied*, 2007 U.S. LEXIS 7736 (2007); *MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert. denied*, 2007 U.S. LEXIS 7868 (2007).

Public Law 86-272, where Congress has determined that mere solicitation is qualitatively *de minimis* relative to the benefits protecting such activities offers to the American economy as a whole.¹⁴

Under BATSA's qualitative *de minimis* provisions, the protected activities include 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 engaging in business activities directly related to the potential or actual purchase of goods or services within the jurisdiction if the final decision to purchase is made outside the jurisdiction. 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.

BATSA's qualitative *de minimis* provisions also protect mere information gathering. Under S. 1726, the furnishing of information to customers or affiliates in a jurisdiction would not give rise to business activity taxation, nor would the coverage of events or other gathering of information in a jurisdiction, where the information is used or disseminated from a point outside the jurisdiction. The basis for these provisions is that the mere furnishing of information is not *market exploitation*. Consequently, and perhaps most important, by protecting these activities BATSA protects the free flow of information in interstate commerce. Finally, establishing these protected areas does not create any complexity because each of the areas is quite discrete and clearly defined.

6. *How is the 14-day quantitative de minimis standard measured?*

The 14-day limitation is measured by each day that a business assigns one or more employees in the state, uses the services of an exclusive agent in the state, or has certain property in the state, regardless of whether such day is a business day. 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 15 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.

7. *Doesn't BATSA, as a result of the 14-day de minimis standard, create an opportunity for certain persons to avoid tax entirely?*

No. The concern is that a business could avoid tax altogether by employing, *e.g.*, traveling salespeople who spend less than 15 days per year in each state. The provisions of BATSA do

¹⁴ Even the OECD Model Tax Convention, which is a benchmark for international taxation jurisdictional standards, recognizes that certain activities should be disregarded. OECD Model Tax Convention, Art. 5.

not apply, however, to commercial domiciliaries of a state – thus, such businesses are taxable on all of their income in the state in which they are commercially domiciled.

8. *How does BATSA address attribution of physical presence to an out-of-state entity?*

BATSA 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 exclusive agent, on more than 14 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.

9. *How does BATSA modernize Public Law 86-272?*

BATSA modernizes the longstanding protections of Public Law 86-272 to include solicitation activities performed in connection with *all* sales and transactions, not just sales of tangible personal property. 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.

BATSA 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.¹⁵ What is most distressing about the New Jersey amendments is that these “gross” taxes apply *only* to businesses protected by Public Law 86-272. In other words, New Jersey has effectively circumvented the Congressional policy decision underlying the enactment of Public Law 86-272 by imposing a non-income tax only on those businesses that would otherwise be protected.¹⁶ While many 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.¹⁷ Texas' adoption of the Texas Margin Tax is an even more recent example of a state enacting a non-income based tax. The Texas Margin Tax is effective during 2007 for calendar year taxpayers, and uses total revenue for the tax base and gross receipts for apportionment.¹⁸

10. *What is the interplay between Public Law 86-272 and BATSA's physical presence nexus standard?*

¹⁵ Yet another example is the gross receipts component of the Michigan Business Tax.

¹⁶ Following New Jersey's lead, Kentucky has also enacted its own alternative minimum assessment, which imposes a gross receipts tax (rather than the state's ordinary income tax) on certain classes of businesses, including corporations that have no property in the state besides property located at the premises of a printer. Ky. Rev. Stat. Ann. § 141.020(1)(h).

¹⁷ 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.

¹⁸ See Tex. Tax. Code § 171.

The business activity tax nexus provisions of BATSA 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 BATSA will not create a physical presence for that business, regardless of whether the protected activities occur in the taxing jurisdiction on more than 14 days.

11. *Why are businesses supporting BATSA?*

Businesses consider BATSA to be extremely important. Its physical presence nexus provisions ensure that interstate commerce pays its fair share of taxes. BATSA need not result in any reduction in taxes paid by businesses; rather, the bill ensures that taxes are paid to those state and local governments that provide the business with benefits and protections (*i.e.*, those jurisdictions where the business has people and/or property). The provisions of BATSA that modernize Public Law 86-272 are equally important because they ensure that there is a level playing field for all businesses engaged in solicitation activities.

12. *Doesn't BATSA infringe upon state sovereignty?*

No. A fundamental aspect of American federalism is that Congress is given the authority and responsibility to ensure that interstate commerce is not burdened by state actions (including excessive taxation of such commerce).¹⁹ 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 BATSA would modernize. A few other examples include:²⁰

- 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;

¹⁹ 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).

²⁰ 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).

- 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;²¹ 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 him or her.

Some critics argue that such measures are too restrictive and violate principles of federalism.²² 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.²³ Moreover, the Supreme Court has explicitly noted Congress’ role in the area of multistate taxation.²⁴

BATSA simply codifies the traditional jurisdictional standards for when a state or local government may impose a tax on a business engaged in interstate commerce; the bill does nothing to determine how a state may tax businesses that are properly subject to its taxing jurisdiction. A state remains free to determine what type of tax to impose, 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 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. BATSA merely confirms that the ability of states to tax is subject to constitutional limitations. Thus, BATSA strikes the correct balance between state autonomy/sovereignty and interstate commerce.

²¹ 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).

²² 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.

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.”).

13. Isn't a physical presence nexus standard a "rollback" of the current law in most states?

No. The physical presence nexus standard in BATSA is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Due Process Clause and the Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus" between the taxing state and the putative taxpayer, whereas the Due Process Clause requires only a "minimum" connection. In *Quill*, the Supreme Court determined that, in the context of a business collecting sales and use taxes from its customers, the substantial nexus requirement could be satisfied only by the taxpayer having a non *de minimis* physical presence in the state; the Court refrained from articulating the appropriate measure for business activity taxes.²⁵ 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?²⁶

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 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).²⁷ Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes.²⁸ 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-

²⁵ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

²⁶ 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 inappropriate because such reliance 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.

²⁷ "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)).

²⁸ See, e.g., *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 558 (U.S. 1977).

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.²⁹ Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.

14. *Haven't state revenue agencies and their representatives projected that BATSA would significantly decrease state revenues?*

There is no basis for the assertion that BATSA could lead to any meaningful loss of state revenues, much less the large revenue loss that state tax officials and organizations assert.³⁰ One of the difficulties that the business community has with the asserted decreases is that there is little empirical data showing where such extensive revenue losses would come from. It is evident when one runs the numbers that passage of BATSA would not lead to significant revenue losses. A comprehensive study of the 2005 BATSA Bill projected that the nationwide revenue loss would be 0.8 percent of the total state and local business activity taxes covered by BATSA³¹ and that the aggregate multi-state revenue loss would be less than one-tenth of one percent of all state and local taxes paid by businesses in 2005.³² The study reached this projection by (1) estimating the current state and local business taxes that are covered by BATSA in each state; (2) determining the sales, by industry, into a state by companies with no establishment in the state; (3) estimating the effective state and local tax rate per dollar of sales and multiplying by the sales for firms without an establishment to determine the taxes paid by firms with no in-state establishments; (4) determining the percentage reduction in these taxes that will occur due to the nexus changes related to each of the provisions in the 2005 BATSA Bill; (5) applying these percentages by major industry group to the taxes associated with sales into the state from companies with no establishment in the state to determine the expected state and local tax losses from the 2005 BATSA Bill; and (6) extrapolating the results from the included states to all 50 states and the District of Columbia.³³

Although a Congressional Budget Office (“CBO”) study asserts that BATSA would produce greater losses than that, the study is flawed in several respects.³⁴ It fails to acknowledge that many states will not lose revenue due to passage of BATSA because many states do not currently

²⁹ 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)).

³⁰ See, i.e., *Congressional Budget Office Cost Estimate: H.R. 1956, Business Activity Tax Simplification Act of 2005*, Congressional Budget Office (reported to House Committee on Judiciary on June 28, 2006). *Impact of H.R. 1956 Business Activity Tax Simplification Act of 2005 On States*, National Governor’s Association (September 26, 2005); Dolores W. Gregory, *New MTC Chief Names Top State Issues: SSTP, BAT Bills and Federal Tax Reform*, 179 DTR G-8 (2005). *But see Response to the National Governors Association Estimates of the State and Local Tax Impact of H.R. 1956*, Council on State Taxation (Oct. 6, 2005), available at www.statetax.org (addressing the shortcomings in the NGA’s estimates of the revenue impact of H.R. 1956).

³¹ Ernst & Young, *Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections*, pg. 3 (July 25, 2006).

³² *Id.*

³³ See *id.*, Appendix B.

³⁴ Congressional Budget Office Cost Estimate, *H.R. 1956 Budget Activity Tax Simplification Act of 2005*

impose income taxes on businesses lacking physical presence in the state.³⁵ It assumes that corporations will restructure operations to take advantage of BATSA's protections but that state and local governments will remain inert and will not enact legislation that will respond to BATSA. It overstates the net short-revenue loss from BATSA because it does not include the increased in-state activities and income that in-state firms, such as independent contractors, would have if out-of-state corporations no longer had nexus in the state.³⁶ It estimates that 67% of the long-run tax impact from BATSA will come from restructuring, thereby relying on projected long term behavioral changes, which are hard to predict and are more speculative than the revenue estimates normally used in the state legislative process.³⁷ It also likely overstates the number of taxpayers that would be affected by passage of BATSA.³⁸

17. *But doesn't the decrease in the corporate tax revenues experienced by the states over the past several years mean that the business activity tax provisions of BATSA are inappropriate?*

No. There are numerous factors that may have contributed to the decline in state corporate tax revenues, both in actual dollars and relative to other types of taxes, *e.g.*, state recognition of the validity of the "integration" concept that the federal government has been adopting,³⁹ a shifting of other tax burdens to corporations, an increase in the share of personal income tax as a result of capital gains, uneven corporate profits, and perhaps most significantly, a drastic increase in pass-through entities as a substitute for corporate form.⁴⁰ In any event, a reduction in state corporate tax revenues does *not* mean that those who receive no benefits or protections from a government should be targeted to compensate for any decrease.

³⁵ Statements by the former executive director of the MTC official confirm that physical presence is the current standard and, thus, indicates that such estimates of revenue loss are overstated:

It seems to me that the states need to face the reality that most of them are generally incapable of enforcing the 'doing business' standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway.

Eugene F. Corrigan, *States Should Consider Trade-Off on Remote-Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

³⁶ Ernst & Young, *Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections*, pg. 7 (July 25, 2006).

³⁷ *Id.* at page 7.

³⁸ There simply cannot be many businesses with zero or minimal physical presence in a state that are currently paying taxes in that state.

³⁹ A study by the Center on Budget and Policy Priorities estimates that federal corporate income tax revenues fell to \$132 billion in 2003, down 36 percent from \$207 billion in 2000 and represent only 1.2 percent of GDP, which is the lowest level since 1983. Joel Friedman, *The Decline of Corporate Income Tax Revenues*, Center on Budget and Policy Priorities (October 16, 2003); Isaac Shapiro, *Federal Income Taxes, as a Share of GDP, Drop to Lowest Level Since 1942, According To Final Budget Data*, Center on Budget and Policy Priorities (October 21, 2003).

⁴⁰ See, *e.g.*, Robert Cline, William Fox, Thomas S. Neubig, and Andrew Phillips, *A Closer Examination of the Total State and Local Business Tax Burden*, 27 State Tax Notes 295 (Jan. 27, 2003).

18. *Do BATSA's attributional nexus provisions permit businesses to restructure their operations to avoid business activity taxes?*

No. BATSA is based on the principle that a business engaged in interstate commerce should pay its fair share of tax.⁴¹ From a policy perspective or from an economic theory perspective, attribution of nexus between two separate and distinct persons is never appropriate. 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 (*i.e.*, the economic activity occurring) in the state. By limiting attribution of nexus only to situations involving market enhancing activities, BATSA not only more accurately reflects the economics of a transaction or business, but also reflects the current state of the law. Expanding attribution any further would undermine the principles of fairness and equity in taxation.

For example, suppose an in-state sales company is retained by an out-of-state manufacturer to perform all of the marketing and selling activities related to the manufacturer's products. The manufacturer is conducting a business activity (manufacturing) and there is no doubt that it is subject to tax in any state where it manufactures. As for the in-state sales company, its selling activities constitute a separate business activity that takes place in its state. The selling activity generates a certain amount of income (*i.e.*, sales commissions) that will be subject to tax in the jurisdiction where the sales company is located, *i.e.*, where the sales activities add value in the economic stream. Thus, both the manufacturer and the seller are properly taxed in the states where they generate income and conduct economic activity.

19. *Will BATSA facilitate the use of "passive investment companies" and other measures that some state tax officials see as "tax shelters"?*

No. Although critics have claimed that BATSA promotes corporate tax shelters, buttressed by a recent study that "estimates" the effect of tax sheltering activities on state revenue,⁴² in an attempt to divert attention from the real issues, in reality, BATSA will not encourage the use of corporate tax shelters or weaken the ability of states to attack such shelters. In fact, with respect to passive investment companies – the most public "tax shelter" – the states have now moved on to using other, more effective attacks, such as the economic substance and alter ego arguments, combination, and the denial of the relevant deductions.⁴³ Each of these weapons will be unaffected by BATSA.⁴⁴ Pretending that BATSA is designed to aid these tax shelters is

⁴¹ A 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).

⁴² See *Corporate Tax Sheltering and The Impact On State Corporate Income Tax Revenue Collections*, Multistate Tax Commission (July 25, 2003).

⁴³ For examples of how two states have addressed these perceived abuses, see Richard W. Tomeo, *Intercompany Transaction: Two State Legislatures Go on the Attack*, J. of Multistate Tax'n and Incentives (Feb. 2003). See also Mary E. Forsbert, *A Question of Balance: Taxing Business in the 21st Century*, 27 State Tax Notes 377 (Feb. 3 2003).

⁴⁴ See Mitchell J. Tropin, *States Moving Away From 'Geoffrey,' Using Sham Arguments, 'Attribution' Nexus*, Daily Tax Report, No. 27 (Feb. 10, 2003).

therefore a false accusation that also ignores the fact that BATSA does not protect these shelters from other tools the states have at their disposal.

20. *How do the provisions of BATSA compare to what the federal government has authorized as a nexus standard for the United States' treaty partners?*

Like most other countries, the United States generally follows the Model Tax Convention of the Organisation for Economic Co-operation and Development (“OECD”).⁴⁵ The OECD Convention reflects a multinational consensus on the international jurisdictional standards governing taxation.⁴⁶ The OECD Model Tax Convention is designed to ensure that taxpayers have a level playing field and a bright-line test for taxation. Specifically, the OECD Model Tax Convention aims to limit double taxation, *i.e.*, situations in which a company is taxed both by the country in which the company is domiciled (“resident country”) and by a country that is the source of all or part of the company’s income (“source country”).⁴⁷ Under the terms of the OECD Model Tax Convention, before a source country may impose a direct tax on a nonresident business’ commercial profits, the putative taxpayer must have a “permanent establishment” in the source country, which is defined generally as “a fixed place of business through which the business of an enterprise is wholly or partly carried on.”⁴⁸ In other words, the OECD Model Tax Convention employs a “physical presence” jurisdictional standard.⁴⁹ This definition of “permanent establishment” creates a rather high threshold for taxation and contains specific examples of activities that do not create a permanent establishment, such as storage of materials in a country.⁵⁰

Not only is BATSA’s physical presence nexus standard consistent conceptually with the OECD “permanent establishment” jurisdictional standard, BATSA actually sets a much lower threshold for the requisite physical presence required before a state can impose a direct tax on an out-of-state business. But BATSA’s physical presence standard accomplishes the same policy goals as the treaties by providing a bright-line standard that is clear and equitable.

It is interesting to note that the OECD in recent years was charged with revisiting the “permanent establishment” concept in light of e-commerce and the changing global economy. In September 2004, an OECD working group approved additional language for the Commentary on the Convention on permanent establishments. The expanded Commentary on permanent establishments reads as follows:

Indeed, the fact that a company’s own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly a company that merely purchases parts produced or services

⁴⁵ Jerome B. Libin & Timothy H. Gillis, *It’s a Small World After All: The Intersection of Tax Jurisdiction at International, National, and Subnational Levels*, 38 Ga. L. Rev. 197, 204 (2003).

⁴⁶ *Id.*

⁴⁷ Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, art. 7 (Jan. 28 2003) (“OECD Model Tax Convention”), n. 1.

⁴⁸ OECD Model Tax Convention, Articles 5, 7.

⁴⁹ See Libin & Gillis, *supra* note 37, at 204.

⁵⁰ OECD Model Tax Convention, Article 5.

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 testimony before the Senate Committee on Finance, Michael F. Mundaca, a participant in the OECD advisory group, explained why the group opted to retain permanent establishment as a standard. Mundaca testified as follows:

[The permanent establishment standard] has created much needed uniformity, predictability, and certainty for multinational corporations and other taxpayers. Moreover, the consensus around the standard helps to mitigate double taxation and prevent tax jurisdictional disputes, which is important in a global economy. Finally, the rule prevents the administrative burden for multinational corporations and other taxpayers of having to file net basis income tax returns in every jurisdiction in which they have customers or other sources of business income.

Mundaca noted, however, that not all countries favor the permanent establishment standard:

That is not to say, however, that there does not continue to be dissent and calls for change. Spain and Portugal, for example, did not join the OECD consensus position, and have pressed the OECD to take up the larger project of assessing whether the PE rules should be fundamentally changed, in light of new technologies and new business models. And countries outside the OECD as well have been pushing for a re-evaluation of the PE standard, in addition to applying the current standard quite expansively.

The United States and other countries for whom the permanent establishment principle is vitally important can expect Spain, Portugal and other similarly situated countries to borrow the economic nexus arguments being made by American state tax administrators to undermine the general acceptance of the permanent establishment principle.

21. Do the international tax jurisdictional standards have a similar concept to attributional nexus?

The OECD Model Tax Convention does not provide for attributional nexus from a nonresident business' employees if the activities of the employees are limited to auxiliary or preparatory functions (provided that the sales are consummated at the nonresident business' home office).⁵¹ This is analogous to the protections provided by Public Law 86-272. In addition, the activities of independent contractors are not attributed to a nonresident business;⁵² for this purpose, an independent contractor must have legal and economic independence.⁵³

22. How does the nexus issue impact job creation and the competitiveness of American businesses?

⁵¹ OECD Model Tax Convention, Article 5.

⁵² *Id.*

⁵³ See *Taisei Fire and Marine Ins. Co. v. Comm'r*, 104 T.C. 535 (1995).

The U.S. economy has been making strong gains in the overall level of growth. 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. 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 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, BATSA 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.⁵⁴ BATSA, 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.

⁵⁴ Indeed, Jan Mundrinich, a lawyer with the West Virginia Tax Department, predicts that “there’ll probably be a lot more litigation” seeking income tax from out-of-state companies unless there is a clear nexus standard. See Jay Hancock, *W. Va. Sets precedent in annals of tax lunacy*, *The Baltimore Sun*, December 20, 2006.

23. *By asserting nexus over businesses that merely have customers in a state, the economic nexus standard effectively taxes a business for taking cash out of a state in exchange for delivery of goods or services into the state. Why is that improper?*

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.⁵⁵ 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.

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 into 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.” (See Question #20). 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.

24. *Why is BATSA’s physical presence nexus standard more appropriate than the factor-threshold proposal suggested by Multistate Tax Commission?*

The physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy⁵⁶ 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.⁵⁷ 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.

On the other hand, the MTC proposal would implement an economic nexus standard for business activity taxes that is based on the “factors” of a business that are assignable to a state.

⁵⁵ See, e.g., *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 11 (1824); *Quill v. North Dakota*, 504 U.S. 298, 313 (1992).

⁵⁶ Richard Pomp, who testified as a tax policy expert on behalf of the taxpayer in *Lanco Inc. v. Director, Div. of Tax’n*, 21 N.J. Tax 200 (N.J. Tax Ct. 2003), *rev’d*, 379 N.J. Super. 562 (N.J. Super. Ct. 2005), 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*, 21 N.J. Tax at 216). Professor Pomp concluded that a physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.*

⁵⁷ 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).

Specifically, the MTC nexus standard is based on the three factors in the standard apportionment formula of the Uniform Division of Income for Tax Purposes Act, or UDITPA: property, payroll, and sales. 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. Whereas a physical presence threshold would permit a state to tax companies with property and payroll in a jurisdiction (albeit not based on the factor threshold approach), the MTC would go further by allowing states to tax businesses that only have customers in a jurisdiction. Because Public Law 86-272 currently protects certain businesses that merely have customers or certain payroll (*i.e.*, salespersons working from their homes) in a state, the MTC has also endorsed the repeal of Public Law 86-272 for those states that enact its factor-based nexus standard.

By establishing this arbitrary threshold based on a business' apportionment factors, the MTC proposal misses the mark on the basic issue. Nexus is concerned with whether a state has the jurisdiction (*i.e.*, the authority) to impose tax on a person. This is an entirely separate question from how much tax a state can actually impose, which is what an apportionment formula is designed to address. In fact, this latter question is not even reached unless a person has nexus with the taxing state. In addition, the factor-based standard, which often would effectively be a single-factor standard based on a business' sales into a state, completely undermines the established policy that a state must provide benefits or protections to a putative taxpayer before a tax liability can be imposed.⁵⁸ Not only does the factor-based standard not require the state to provide any benefits or protections to taxpayers, the standard would significantly increase the risk of taxation of the same income by multiple jurisdictions.

Finally, the MTC proposal is not as straightforward as its proponents suggest. First, it is not simply a matter of computing three factors – a business operating in multiple jurisdictions must grapple with different definitions of what is included in each factor and different rules for whether unitary filing is required or permitted and, if so, what constitutes a unitary business. All of this is in addition to the dramatic state-by-state variations in apportionment schemes, filing requirements, modifications, and net operating losses. True, multistate businesses currently must calculate the factors in each state in which they do business. By eliminating the protections of Public Law 86-272, however, the MTC proposal would significantly increase the number of states in which businesses would be subject to tax. Consider the impact of the MTC proposal on a small family-owned company. Even under the current nexus rules, many family-owned corporations struggle to comply with state and local income tax requirements. This is further complicated if the family business is a pass-through entity, such as a limited liability company or a Subchapter S corporation, in which case the company must also satisfy the income tax requirements of the jurisdictions in which its shareholders reside. The MTC proposal would only exacerbate this problem by increasing the number of jurisdictions in which such a company has nexus. Surely, this would only serve to discourage corporate growth and expansion, which is contrary to the current efforts to stimulate the economy.

⁵⁸ In fact, the sales factor was only included in UDITPA as a political measure to gain the support of the states; prior to UDITPA, the inclusion of the sales factor in apportionment was criticized by economists because it did not accurately reflect what actually creates income (*i.e.*, labor and capital employed in a state). *See, e.g.*, Charles E. Ratliff, Jr., *Interstate Apportionment of Business Income*, XV Nat'l Tax J. 260 (1962); John Dane, Jr., *An Evaluation of the Income Tax Provisions of H.R. 11,798*, XIX Nat'l Tax J. 104 (1966).

Even if the MTC's factor-based test would provide a more clear and administrable test for nexus than would BATSA or current law, that fact alone cannot be the sole justification for implementing a bad policy. Clearly, the factors that the MTC proposal would use for nexus purposes are not elements of an acceptable nexus standard.

25. *Why does BATSA extend the current law's protection of the activity of salespersons when the Multistate Tax Commission would eliminate Public Law 86-272?*

Public Law 86-272 was enacted in response to the Supreme Court's decision in *Northwestern States Portland Cement*. Contrary to statements by proponents of its elimination, Public Law 86-272 was not simply small business protection legislation; to describe the law solely in those terms is disingenuous. In actuality, the purpose of the legislation was to protect small businesses *and* all other businesses from being taxed in states in which they have minimal nexus.⁵⁹ The policies underlying Public Law 86-272 remain valid today – if anything, they are more pressing in that Public Law 86-272 does not provide enough protection to ensure a continuing healthy American economy.

The protections offered under Public Law 86-272 and BATSA apply only when a company does not have an office in the state. The very nature of a salesperson's activity in a state on behalf of an out-of-state company is so *de minimis* that business activity taxes should not be applied because of this activity.

In addition, exempting businesses from tax when their in-state activities were limited to solicitation has been a settled policy since the enactment of Public Law 86-272 in 1959 when Congress decided that any benefits received from a state as a result of a salesperson's activity in such state were outweighed by the benefits to the U.S. economy as a whole. Permitting companies to send salespersons across state lines without fear of taxation solely because of the salesperson's presence makes for a strong and unified American economy. On the other hand, without the exemption, there would be a disincentive for a company to market its products in other states, as well as an uneven playing field relative to companies with other marketing strategies that did not include salespersons. This would have an adverse impact on the American economy.

26. *Don't businesses that have customers within a jurisdiction receive benefits from that jurisdiction's maintaining a market for the business?*

Proponents of an economic nexus standard for business activity taxes argue that, if a business has a customer in a jurisdiction, the jurisdiction should be able to impose tax on the business, even if the business conducts no operations and has no people or property there. As a policy matter, they assert that states maintain a marketplace (*i.e.*, educated customers and an infrastructure) from which out-of-state businesses are profiting and, thus, those businesses should contribute to the maintenance of that marketplace. Yet the idea that a business should be required to pay tax to a state for some nebulous benefits received defies common sense and is inconsistent with current law. In fact, Charles McClure, whose insights are heavily relied upon by the MTC proposal and its advocates, has recognized that:

⁵⁹ See S. REP. NO. 658, *reprinted in* 1959 U.S.C.C.A.N. 2548.

The basic point is that most public services are provided to households, not to businesses. . . . Beyond that, there is no reason to think that businesses require more public services because they purchase inputs, instead of producing the inputs themselves. Corporate income taxes are not likely to reflect benefits of public services because services are not provided only to businesses that are organized in corporate form, they are not likely to be provided only to corporations that are profitable, and they are not likely to increase in direct proportion to profits.⁶⁰

If businesses in general receive relatively little government benefits, out-of-state businesses merely having customers in the state obviously receive even fewer benefits or none at all.

In *Wisconsin v. J.C. Penney Co.*,⁶¹ the Supreme Court determined that “[t]he simple but controlling question is whether the state has given anything for which it can ask return.” Governments provide their protections and services for the benefit of those individuals and businesses physically present in the jurisdiction. Whether it is fire and police protection, education services, social services, or transportation facilities, those persons who are *actually there* get the benefits. In the case of a business with no material property or personnel in a taxing jurisdiction, it is clear that there are no benefits provided by the taxing jurisdiction that can justify the imposition of tax by such jurisdiction.

It should be noted that residents of the jurisdiction who patronize remote sellers benefit from such purchases to the same extent that the sellers are benefiting (as must obviously be the case in any free market society, where a buyer and seller each believe that he or she is “getting a good deal” when each gives up something he or she already has for something else). Should such resident customers thus be required to pay tax to the remote jurisdiction where the seller is located because the seller’s jurisdiction is providing the protections and benefits that allow the good or service to be produced for the benefit of the customer? The answer is clearly no because to require persons to pay tax to states in which they have no physical presence and therefore no voice in the local government that provides the supposed benefits – merely because such person receives certain tangential and unquantifiable benefits – is a clear case of taxation without representation.

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.⁶² 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.”⁶³ 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

⁶⁰ Charles L. McClure, *The Nuttiness of State and Local Taxes – And the Nuttiness of Responses Thereto*, 25 State Tax Notes 841 (Sept. 16, 2002).

⁶¹ *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

⁶² 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)).

⁶³ Op. N.Y. Att’y Gen. 301 (May 29, 1919) (emphasis added).

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.

27. Doesn't the fact that states provide benefits to the country as a whole mean that all businesses in the country should contribute to the tax revenues of all states?

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."⁶⁴

28. How do BATSA's business activity tax nexus provisions compare to the majority report of the Federal Advisory Commission on Electronic Commerce?

The business activity tax concepts in BATSA are similar to the recommendations of the majority report issued by the ACEC. 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.⁶⁵ Consistent with this conclusion, BATSA provides for a bright-line physical presence standard

⁶⁴ 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

⁶⁵ See Advisory Commission on Electronic Commerce, *Report to Congress*, pp. 21-22 (April 2000).

that recognizes that certain instances of “presence” are qualitatively *de minimis*.⁶⁶ As a result, BATSA is more conservative and actually provides states with more opportunity to tax interstate commerce than would be available under the ACEC majority report recommendation.

29. What is the relationship between economic nexus and 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.

A less obvious tax incentive occurs when states adopt apportionment formulas that weigh 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 of the state. Not only does this offend the basic principle of nondiscrimination that is required by the Commerce Clause of the U.S. Constitution,⁶⁷ 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.

30. How will BATSA affect the amount of controversy and litigation?

BATSA provides simple and identifiable standards that will significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government. While it is unrealistic to expect BATSA to end all controversies concerning 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 reported decisions. On the other hand, areas outside its coverage have been litigated extensively and at great expense. In recent years, the focus of most state tax litigation has been on what the appropriate nexus standard for business activity

⁶⁶ H.R. 2526 and S. 664 from the 107th 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 in the last Congress 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); BATSA also follows this approach.

⁶⁷ 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 actually is;⁶⁸ there is no indication that this issue will be settled absent Congressional action.

31. Isn't BATSA an unfunded mandate?

An “unfunded mandate” is a congressional measure that requires a state or local government to either expend its own revenues to meet a federal goal or to forgo some of its revenues.⁶⁹ If the total direct costs of such a measure exceed \$57 million (the 2003 threshold, as adjusted for inflation), the measure is an unfunded mandate.

BATSA does not technically require states to forgo revenues from business activity taxes, but merely to adhere to certain minimum constitutional standards before imposing a business activity tax. Any negative revenue impact that might occur by the codification of the physical presence standard should be negligible.

In any event, characterization of legislation as an unfunded mandate does not mean that Congress may not enact it. Rather, Congress must simply comply with additional measures in order to pass the legislation. The Unfunded Mandates Reform Act of 1995⁷⁰ requires the authorizing committees of the legislation to include information about unfunded mandates in their legislative reports, requires the Congressional Budget Office to estimate the costs of the new requirements, and subjects the mandate to a point of order that must be specifically approved by a majority of the members of Congress.⁷¹ Congress is therefore required to consider the issue of unfunded mandates but it may still pass legislation imposing federal unfunded mandates when the merits of the legislation are found to override any negative impact. Even if BATSA contains unfunded mandates that require Congress to pursue the procedures imposed by the Unfunded Mandates Reform Act of 1995, which is unlikely, BATSA is vital to both the states and the American economy.

⁶⁸ See *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 U.S. LEXIS 6033 (2005); *Lanco, Inc. v. Director, Div. of Taxation*, 188 N.J. 380 (N.J. 2006), *cert. denied*, 2007 U.S. LEXIS 7736 (2007); *MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert. denied*, 2007 U.S. LEXIS 7868 (2007); *Acme Royalty Co. v. Dir. of Revenue*, 96 S.W.3d 72 (Mo. 2002); *Rylander v. Bandag Licensing Corp.*, Tex. App. Ct., No. 03-99-004217-CV (May 11, 2000); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *app. denied* (Tenn. 2000), *cert. denied*, 531 U.S. 927 (2000); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995) (*cf. Lanzi v. State of Alabama Department of Revenue*, Ala. Dep't of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003)); and *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S.C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 (1993).

⁶⁹ The Unfunded Mandates Reform Act of 1995 defines a mandate as “the aggregate estimated amounts that all State, local, and tribal governments would be required to spend or would be prohibited from raising in revenues in order to comply with the Federal intergovernmental mandate.” 2 U.S.C. §§ 658(3)(A)(i), (5). Enforceable duties that arise from participating in a *voluntary* federal program are not mandates. 2 U.S.C. § 658(5)(A)(i)(I).

⁷⁰ P.L. 104-4, 109 Stat. 48.

⁷¹ 2 U.S.C. §§ 658b, 658c, and 658d.