

**Testimony of the
Council On State Taxation (COST)
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Hearing on H.R. 5267, the "Business Activity Tax Simplification Act of 2008"

Before the

**United States House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law**

The Honorable Linda T. Sánchez, Chairman

June 24, 2008

The Council On State Taxation, which is more commonly known as COST, welcomes the opportunity to share with you COST's views on the important issue that you have before you—the appropriate extent of state jurisdiction to tax. COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of more than 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

Our comments address two fundamental questions at issue:

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

BAT Nexus Needs Congressional Action

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

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

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

The uncertainty created by conflicting interpretations of the Constitutional standard for tax jurisdiction has long resulted in unnecessary administrative and litigation expense for both taxpayers and states, and will certainly increase the costs and risks of operating a multistate business in the foreseeable future. For example, the recent Financial Accounting Standards Board Interpretation No. 48 (“FIN 48”) of its Statement 109 (Accounting for Income Taxes) shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards. FIN 48 appropriately seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes. However, the lack of any national, definitive authority for state tax jurisdiction complicates the analysis under FIN 48 and creates an ongoing dilemma for multistate companies. If a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment often never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence

level (“more likely than not”) on the validity of its financial statement reporting position under FIN 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear from its financial statements unless the business is actually audited and the state determines it does not have nexus. This is but one example of how the current uncertainty over the scope of the nexus requirement creates confusion beyond the immediate tax effects.

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

Physical Presence is the Appropriate Standard

It is COST’s position, in order for a State or a locality to impose a business activity tax on a business, that a business must have a physical presence in the jurisdiction. Congress must recognize physical presence as the jurisdictional standard for business activity taxes. Physical presence should be defined to include quantitative and qualitative de minimis thresholds. Congress must also prohibit unreasonable attribution of nexus. Finally, Congress must preserve and modernize P.L. 86-272. Legislation currently pending in both the Senate and the House of Representatives would accomplish all of these goals.

Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens—economic as well as administrative—only on businesses that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means that businesses that are not physically present in a jurisdiction and are therefore not receiving meaningful benefits or protections from the jurisdiction should not be required to pay tax to that jurisdiction. Such a test also delineates a

clear line to guide both businesses and the states (including their localities) on when a business can be subject to a State's tax.

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

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

Indeed, some former tax administrators have recognized the problems inherent in an economic presence nexus standard. A former Multistate Tax Commission Executive Director, Eugene Corrigan, has argued "that the states need to face the reality that most of them are

generally incapable of enforcing the “doing business” [economic presence] standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general—and with mixed success, at best.”

Conclusion

A properly constructed bright-line physical presence nexus standard will promote fairness, eliminate uncertainty for both businesses and states, and significantly reduce the frequency and costs of litigation. We are very interested in working with this Committee and other interested parties to articulate a bright-line physical presence nexus standard that is fair to both business and government.