



**Software Finance & Tax Executives Council**

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BEFORE THE COMMITTEE ON THE JUDICIARY,  
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,  
UNITED STATES HOUSE OF REPRESENTATIVES  
HEARING ON STATE TAXATION:  
THE ROLE OF CONGRESS IN DEFINING NEXUS

FEBRUARY 4, 2010

STATEMENT FOR THE RECORD

The Software Finance and Tax Executives Council (SoFTEC) thanks the Chairman and Ranking Member for the opportunity to submit this statement for the record on the Subcommittee's hearing on the role of Congress in defining "nexus." SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting. Many SoFTEC members provide their products and services to customers in multiple states and face the possibility of tax compliance burdens in states in which a revenue department might assert that they have "nexus." Because the concept of "nexus" is ill-defined, SoFTEC members face uncertainty over whether they have tax compliance burdens in states where they have no property or employees. Thus, SoFTEC has an interest in providing the Subcommittee with its perspective on Congress's role in defining "nexus."

**What is Nexus:**

"Nexus" generally is the jurisdictional predicate that must exist before a state is permitted to exert its taxing power over a nonresident taxpayer and is of constitutional dimension, finding its roots in the Due Process and Commerce Clauses. The Supreme Court, in its most recent "nexus" decision described Due Process "nexus" as follows:

The Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill v. North Dakota*, 504 U.S. 298, 306 (1992), quoting *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954).

The Court in *Quill*, in discussing the Commerce Clause aspect of "nexus," went on to note that the Commerce Clause requires "a substantial nexus and a relationship between the tax and State

provided services,” which “limit the reach of State taxing authority so as to ensure that State taxation does not unduly burden interstate commerce.” *Id* at 313.

Thus, in order for a state to assert its taxing authority over an out-of-state taxpayer, such taxpayer must have a “substantial nexus” with the taxing state. This is where the clarity ends and the uncertainty begins, since the question of when and whether a taxpayer’s “nexus” or connection with the taxing state is “substantial” is almost always a question that turns on the facts and circumstances of each individual case.

In the case of sales and use taxes, we know that the “substantial nexus” requirement is met when the taxpayer has a “physical presence” in the taxing state. See *Quill, supra*. However, there are disputes between taxpayers and tax administrators over whether a taxpayer’s physical presence is *de minimis* and not sufficient to trigger a tax compliance obligation, or substantial enough to require the collection of sales and use taxes from customers. See e.g., *Amazon.com LLC v. New York State Dept. of Taxation and Finance*, \_\_\_ N.Y.S. 2d \_\_\_, 2009 WL 69336 (N.Y. Sup. 2009).

Whether the physical presence “nexus” standard applied by the Court in *Quill* to sales and use tax collection obligations extends to other types of taxes, such as income or other business activity taxes, is the subject of much litigation. See, e.g., *Geoffrey v. South Carolina Tax Commission*, 313 S.C. 15 (1993) (physical presence test of *Quill* does not apply to state income taxes); *J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999) (physical presence required for imposition of corporate net income taxes).

Thus, depending on the state, physical presence may or may not be the nexus standard for determining when an out of state taxpayer has an obligation to pay a state’s business activity tax. Since the Court’s 1992 decision in *Quill*, the Court has not clarified the “nexus” requirement for imposition of state taxes on interstate commerce; the Court declined to take any of the several petitions for certiorari that raised the issue.

Additionally, attempts by some states to impose a business activity tax on a non-resident business that has no physical presence is out-of-step with international tax treaty norms which even permit foreign firms a limited amount of physical presence before they will subject it to local taxes. See Model Tax Convention on Income and Capital, Organization for Economic Co-Operation and Development. Thus, a foreign firm with no physical presence in a state could be subject to state taxes but, because the federal government has a tax treaty with the firm’s host country having a different jurisdictional standard, the firm would not be subject to federal income taxes. There is no sound policy basis for this disconnect and no reason why the states should be allowed to be so out-of-step with international tax norms.

### **Congress Has a Role;**

There is no question that Congress has a role to play in bringing clarity to the definition of “nexus.” First, the Supreme Court has noted that Congress is best suited to resolve these issues:

This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, [n.10] but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions.

*Id* at 318.

The Supreme Court thus has made it clear that Congress, pursuant to its power under the Commerce Clause, is the ultimate arbiter when it comes to defining the contours of the interstate taxing powers of the states. Indeed, the above quote from the *Quill* decision seems almost an invitation for Congress to exercise such power. The fact that the Court has not spoken on the issue of “nexus” in the 18 years since it issued the *Quill* decision suggests that the Court is disinclined to offer much needed guidance with respect to these issues.

Additionally, the Congress previously used its power under the Commerce Clause to provide some guidance for interstate taxpayers. In 1959, in response to the Supreme Court’s decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U. S. 450 (1959), Congress enacted P.L. 86-272 prohibiting states from imposing net income taxes on out-of-state taxpayers whose only contacts with a state were the solicitation by employees or representatives of a seller of orders for sales of tangible personal property where the orders were sent out of the state for acceptance and were fulfilled by shipment or delivery from a point outside the state. See 15 U.S.C. Sec. 381.

The problem with P.L. 86-272 is its 1959 vintage. P.L. 86-272 does not encompass the myriad interstate business practices which have grown up since the enactment. Because it is limited to sales of tangible personal property, P.L. 86-272 may not apply to licenses of software nor sales of electronically delivered services, business models that did not exist in 1959. Nor does P.L. 86-272 encompass other types of state taxes, such as gross receipts taxes, which were not in favor at the time of its enactment and which states have since imposed in order to circumvent P.L. 86-272’s protections.

States are becoming increasingly aggressive in pursuing out-of-state companies with no physical presence in the taxing state for state income or other business activity taxes. These companies with no physical presence consume no state resources for which they ought to compensate. These states seek to export their tax burden to taxpayers who play no role in the political life of the state.

### **Congress Should Act:**

As noted above, there is confusion and uncertainty over the application of the “substantial nexus” standard and Congress has the power under the Commerce Clause to address clarify when out-of-state taxpayers have a tax obligation to another state. There is legislation pending, The Business Activity Tax Simplification Act of 2009, H.R. 1083 (“BATSA”). This legislation would make it clear that an out-of-state firm has no obligation to a state for a tax based on business activity unless the firm has a physical presence in the state. The bill would clarify what physical presence means and quantify the level of physical presence a firm must have in a state

before a tax obligation arises (Congress also should adopt a similar bright-line standard for sales and use tax collection obligations). The bill would modernize P.L. 86-272 so that it applies to software licenses, sales of services and other types of business activity taxes.

BATSA has the support of a majority of the House Judiciary Committee and we urge the subcommittee to mark the bill up and report it to the full committee at its earliest opportunity.

**Conclusion:**

SoFTEC thanks the Chairman and ranking member of the Subcommittee for holding this important hearing and for the opportunity to submit these remarks and ask that they be made a part of the record of the hearing.