STATEMENT OF

DAN R. BUCKS
DIRECTOR, MONTANA DEPARTMENT OF REVENUE

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

HOW MUCH SHOULD BORDERS MATTER? TAX JURISDICTION IN THE NEW ECONOMY
S. 2721 – BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

July 25, 2006

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear before the Subcommittee on the issue of "How Much Should Borders Matter? Tax Jurisdiction in the New Economy." I will address this issue generally, but focus my remarks on S. 2721, the Business Activity Tax Simplification Act since that it is the piece of legislation actively before the Committee.

I am Dan Bucks, Director of Revenue for the State of Montana. I am appearing here today at the request of the ranking member of the full Committee, Senator Baucus. I appear in support of cooperation between the states and the federal government in developing tax policies that fit with the new economy and in opposition to S. 2721 and the concepts underlying that bill. The arguments I am making today in opposition to S. 2721 are consistent with policy positions adopted by the National Governors Association as well as the Federation of Tax Administrators and the Multistate Tax Commission, two organizations comprised of state tax administrators from across the country.

Overview

There are strong reasons for the federal government and the states to engage in cooperation instead of conflict. The full Finance Committee has played a key leadership role in curbing abusive tax shelters and insisting that transactions reported for tax purposes reflect economic substance. Because state income taxes are linked to the federal tax, states benefit from and appreciate greatly the committee's work in restoring greater integrity to the income tax system. In turn, a growing number of states have added their own enforcement efforts—supplementing federal resources--to help clean up the abusive tax shelter mess.

This Subcommittee and the full Finance Committee have contributed to the development of a more open world economy. The evolution of the world trading system creates new challenges for the equitable and effective operation of tax systems. States have much to offer the federal government in understanding how to make income taxes work in the global economy. Because the U.S. Constitution established the world's first modern common market, states have dealt with these issues for nearly a century. Using the same principle that taxes should reflect economic substance, not taxpayer choice, states have forged income tax practices to ensure that business income is fully reported in reasonable relationship to where it is earned. Key elements in ensuring the full and proper accountability of income include economic presence for jurisdictional purposes and dividing income among states in proportion to actual business activity. These practices pioneered by the states—and once summarily rejected by international tax authorities--are now getting fresh attention by those same authorities. The federal government is now dealing with the improper shifting of income internationally through the use of offshore intellectual property holding companies. Many states are solving the same problem domestically by enforcing economic presence jurisdictional standards. We urge Congress not to engage in conflict with the states through preemption, such as is represented by S. 2721—a bill that is the antithesis of cooperation. We urge you to reject that bill and the outmoded physical presence concepts on which it is based. Instead we urge the federal government to engage in cooperative efforts with the states to learn from our respective experiences and shape tax practices based on economic substance and the reality of business operations in the world economy.

More specifically, I ask you to oppose S. 2721 for several reasons:

1. The bill will legalize tax shelters that states consider abusive and would disallow under current law. Tax shelters blessed by this bill will allow many multistate and multinational corporations to reduce their state tax liabilities to virtually zero. Aiding and abetting inappropriate corporate tax planning in this manner runs counter to the actions this Committee has taken to reduce tax sheltering at the federal level.
2. The bill constitutes a huge and unfair unfunded mandate on the states, which if enacted, would constitute the largest unfunded by Congress on the states.. The Congressional Budget Office estimates (conservatively, in my mind) that the tax sheltering allowed by the bill will reduce state revenues by $3 billion per year in 2011 and place at risk even larger sums running up to 75% of the business income tax base of the states. The revenue losses imposed by the bill will shift the tax burden away from large, multijurisdictional enterprises to smaller, local businesses.
3. The bill distorts investment decisions and harms the economic development of the states—especially more rural states whose local economies are dependent on the smaller, local businesses that will bear the brunt of the tax shift imposed by this bill. Physical presence standards of nexus for tax purposes act as a trade barrier that create a disincentive for companies to invest in the states where they market their goods and services and from which they earn profits. The bill undermines local communities by harming existing small businesses and discouraging new investment by enterprises committed to participating directly in the life of those communities.
4. The bill does significant harm to our federal system and overturns established constitutional precedent on the jurisdiction of states to impose tax on entities doing business in the state.
5. The manner in which P.L. 86-272 is expanded in the bill is without justification and runs contrary to all efforts to establish an effective and equitable state tax system in the 21st century.
6. The bill protects large businesses at the expense of small ones and favors out of state businesses over in-state taxpayers.
7. The states have developed a straightforward bright line nexus standard for business activity taxes that is consistent with existing constitutional standards and is in tune with the 21st Century economy. Unfortunately, that standard has been summarily been rejected by the business community that continues instead to insist on an outdated physical presence nexus standard that promotes inappropriate state tax sheltering.

I. S. 2721 legalizes abusive tax shelters at the state level and runs counter to the efforts of the Finance Committee to reduce tax sheltering at the federal level.

By expanding the scope of P.L. 86-272 (both in terms of the types of state business activity taxes covered and the types of activities in which an entity may engage without being considered to have a taxable presence in the state) and by establishing a physical presence nexus standard in federal law (along with all the attendant 'carve-outs' in the bill),[1] S. 2721 creates a virtual road map that will allow multistate and multinational corporations to structure their operations and to shelter various sources of income so as to reduce significantly or eliminate their state tax liability.[2] There are an almost infinite number of ways in which the bill could be used to avoid state business activity taxes, some of which are discussed below. Simply put, however, an entity can avoid state business activity taxes under the bill by locating its physical assets (property and payroll) in low-tax or no-tax jurisdictions and then limiting its activities in market states only to those activities shielded by P.L. 86-272 or conducting its operations in the market state through third parties or other remote means. Further S 2721 would encourage businesses to reorganize holding companies, management companies, etc. in low-tax or no-tax states and shift income from the states in which the incomes is earned.

Comment: PL 86-272 already shields sellers of tangible property from state taxation.

The result of such sheltering is obvious:

(a) An appropriately structured operation can avoid business activity tax liability and still exploit the marketplace in any given state;

(b) In-state entities subject to state taxes face an unfair competitive disadvantage;

(c) The state tax base is seriously eroded;

(d) Business income and operations are not subjected to tax where the income is earned; and

---

[1] Other features of the bill such as the ability to use contractors in a state without their activities being attributed to an entity for purposes of determining nexus and the classification of software licenses in the bill also create sheltering opportunities.

[2] "Tax sheltering," for state business activity tax purposes, means that income is not being fully reported to each state in a manner that "fairly represents" the business activity actually being conducted by the enterprise in each state in proportion to the property it uses, the people it employs or the sales it makes in each state. "Fairly represents" is a policy standard established in the Uniform Division of Income for Tax Purposes Act (UDITPA), as proposed by the American Bar Association.

(e) (e) The state business activity tax falls unevenly across similar types of businesses, depending solely on whether they have taken advantage of the sheltering opportunities afforded by the bill.

A Simple Example. One of the more common sheltering schemes is the use of an intangible holding company to shift income of retailers with many stores in a state to a low-or-no-tax state. The retailer's trademarks are moved to a holding company established in a low-or-no-tax state, and the affiliate with the stores then transfers its profits to the holding company through royalty payments that are deducted as a current expense. This effectively transfers income earned in the states where the stores are located (by a company with a very substantial physical presence in those states) to another state that might not tax that income. Currently, this is considered somewhat risky tax planning because some state courts have held such arrangements to be illegal. (See discussion below.) There could be substantial penalties and interest facing a corporation that loses such a case. If S. 2721 becomes law, that risk will disappear; a state would be prohibited from taxing the holding company to which the income earned in the state was shifted because the holding company would not have a physical presence in the state. Further, these shifting schemes would become not just standard, but required, tax planning due to the fiduciary duties that corporate boards of directors owe to their shareholders.

Others have noted the effect of S. 2721 on tax planning as well. Professor John Swain (University of Arizona) writes in the William and Mary Law Review that **"**the physical presence nexus test motivates taxpayers to avoid physical presence in some jurisdictions while shifting property and payroll to tax havens."[3] Likewise, a Congressional Research Service analysis drew this conclusion:

> "The new regulations as proposed in H.R. 1956 and S. 2721, would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have expanded the opportunities for tax planning and thus tax avoidance and possibly evasion." [4]

---

[3] John Swain, "State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective," William and Mary Law Review, Vol. 45, Issue 1, 2003.

[4] Steven Maguire, ***State Corporate Income Taxes: A Description and Analysis***, CRS Report for Congress, Order Code RL32297, updated June 14, 2006, p.16.

The Center on Budget and Policy Priorities has also commented extensively on the undesirable effects of federal business activity tax nexus legislation and how it promotes inappropriate tax sheltering.[5] The Center has also examined challenged the arguments made in support of S. 2721, and that document is commended to you for review.[6]

Federal Anti-sheltering Activities. It is more than a little ironic and incongruous that Congress would consider legislation such as S. 2721 that promotes tax sheltering at the state level when it has, with the leadership of the Committee on Finance, taken a number of steps to eliminate or reduce the effects of sheltering under the federal income tax. Among the actions taken by this Committee and the Congress to combat federal sheltering are:

- Enactment of legislation establishing a "listed transactions" regime a registration requirement for listed transactions, notification to the IRS and an enhanced penalty regime for engaging in listed transactions;
- Support for several IRS Voluntary Compliance Initiatives for shelter participants that secure payment of taxes, interest and penalties due on shelter transactions in return for avoiding criminal prosecution and steeper penalties;
- Investigations into the role of tax shelter promoters and advisers in spreading the use of illegal shelter transactions;
- Efforts to codify the "economic substance" rule in order to strengthen the hand of IRS in dealing with sham transactions that result in sheltering;
- Investigations into the role of non-profits as parties to tax shelter transactions and consideration of remedial legislation;
- Efforts to identify the causes of the tax gap and to push Treasury and IRS to bring forth proposals to narrow the gap;
- The review of advanced pricing agreements and other international tax provisions in an effort to reduce tax planning and sheltering;

[5] See, for example, Michael Mazerov, "Proposed 'Business Activity Tax Nexus Legislation' Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy," Revised July 20, 2006. [Available at http://www.cbpp.org/9-14-04sfp-sum.htm. See also Michael Mazerov, "Federal 'Business Activity Tax Nexus' Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes," Revised May 9, 2005. Available at www.cbpp.org.

[6] Michael Mazerov, "Proponents Case for a Federally-Imposed Business Activity Nexus Standard Has Little Merit," Revised July 20, 2006. Available at http://www.cbpp.org/6-20-06sfp.htm.

Additional Examples. The following 4 scenarios were developed by a team of Kansas auditors, attorneys and policy analysts who met recently to evaluate the fiscal impact of HR 1956. These examples are equally relevant to S. 2721. They looked at the manufacturing, retail and service sectors of the Kansas business tax base, analyzed the proposed legislation, and then figured out how certain businesses could lower their taxes using the "safe harbors" to allow businesses that already have physical nexus with Kansas to substantially reduce their tax liabilities. The examples are drawn from testimony provided to the Commercial and Administrative Law Subcommittee of the House Committee on the Judiciary by Joan Wagnon, Secretary of the Kansas Department of Revenue on September 27, 2005. In Montana, a similar team of auditors, attorneys and analysts reviewed these examples and found them to be equally applicable and negative in their effects on the equity and integrity of our state tax base. We might substitute different industry examples, but the analysis and impact is the same.

Manufacturer scenario

Company A makes tires in Kansas and sells them nationwide. In order to take advantage of H.R. 1956 safe harbors, company A breaks itself up into several separate entities: company B owns/leases the plant facility and equipment in Kansas, company C, located out-of-state, owns/leases the materials used to make the tires, and company D employs the Kansas factory workers. All remain commonly owned. Under the safe harbor for manufacturing materials (up to the point those materials become the finished product/inventory), company C has no nexus with Kansas, and the value of the materials at the Kansas plant owned/leased by company C would appear to be excluded from the numerator of the property factor, thus reducing the Kansas apportionment factor, and Kansas' share of any taxable business income.

This same scenario could apply as well to an aircraft manufacturer in Kansas. An affiliated out-of-state entity owns/leases the materials (up to the point they become the finished product) being manufactured into aircraft. Another entity owns/leases the Kansas manufacturing facility, and yet another employs the Kansas factory workers. The owner of the materials and unfinished produced items would appear to be shielded from nexus under an H.R. 1956 safe harbor.

Retailer scenario

An out-of-state retailer of computers or other electronic devices markets its products to Kansas customers via the Internet. The sale of computers and electronic devices includes warranty contracts. The out-of-state retailer contracts with an independent contractor located in Kansas to provide the warranty service to its Kansas customers. The independent contractor provides similar services to other out-of-state retailers, all of which could be affiliates of one another. Under

the independent contractor safe harbor in H.R. 1956, the out-of-state retailer now has no nexus with Kansas.

Financial Services Scenario
Kansas financial services company H breaks itself into companies I and J, which remain in Kansas, as well as broker K, which is located out-of-state. Broker K services the Kansas customers of companies I and J via Internet, mail or telephone. Income earned by broker K on sales of financial services to Kansas customers will no longer be taxable by Kansas.

Information/software Services Scenario
A Kansas company providing information and software support services to businesses in Kansas and other states breaks itself into in-state information services company X, in-state software support services company Y, and an out-of-state sales agency Z. Companies X and Y wholesale their services to agency Z, who in turn sells the services to businesses in Kansas, delivering the services via the Internet. Income earned by agency Z on sales of information and software services provided to Kansas customers will not be taxable in Kansas.

These scenarios do not, by any means, exhaust the examples of tax sheltering that would be legalized by S. 2721. The important point is that these and other cases constitute improper tax sheltering because in each instance they allow businesses to earn substantial profits in a state without paying taxes to that state on those profits, or in many instances to any state at all.

II. S. 2721 constitutes a huge unfunded mandate on states and localities. The Congressional Budget Office estimates that a substantially similar House bill (H.R. 1956) will reduce state revenues by $1 billion in 2007 and by $3 billion per year in 2011.

On July 11, 2006, the Congressional Budget Office released a cost estimate on H.R. 1956, the Business Activity Tax Simplification Act of 2005, the House counterpart to S. 2721. Some excerpts from that report follow:

> CBO estimates that enacting H.R. 1956 would result in revenue losses for states and some local governments and that such losses likely would total more than $1 billion in the first full year after enactment. We estimate that forgone revenues would grow to about $3 billion annually by 2011. (P. 3)
>
> CBO expects that all states and some local governments would see an immediate

> revenue loss because they are currently collecting taxes from firms that would be exempt from taxation under the bill. This initial effect would likely exceed $1 billion, annually, nationwide. Subsequently, it is likely that corporations would rearrange their business activities to take advantage of beneficial tax treatments that would result from the interaction of the new federal law and certain state taxing regimes. CBO expects that these reorganizations would occur during the first five years after enactment of the legislation and estimates that forgone revenues to state and local governments would likely total about $3 billion, annually, by 2011. (P. 4)
>
> Overall, we estimate that about 75 percent of total income from BATs could be at risk under the bill. (P. 5)

While the estimate provided by CBO involves substantial revenues, state tax administrators believe it represents the low-end of the possible range of impacts, based on work done by states using tax return information and the knowledge they have of their state economies and taxpayer population. In a study released in September 2005 by the National Governors Association, states estimated that H.R. 1956 would reduce state revenues by $4.8 billion to $8.0 billion, depending on how widely the tax planning blessed by the bill was exploited by businesses. While the CBO and NGA estimates differ they both involve substantial sums of revenue, they are clearly on the same order of magnitude and they both indicate that the revenue losses from the bill grow as the companies adjust their operations to exploit the loopholes provided by the bill. Replacing the revenues lost from this bill will, of course, require reductions in vital services or a shifting of the burden to other taxpayers.

At the time of the NGA study, we estimated the impact in Montana as beginning in the first year at $3 to $6 million dollars and growing within five years to $25 to $35 million annually—or 30% to 40% of our corporate tax revenues . That revenue loss is equal to all of the money that Montana spends annually to operate our state mental health facilitates, or our state prison, or all of our services to needy families and children. Based on more recent trends in corporate revenues, the same 30% to 40% loss of corporate tax revenues now translates into an even larger $45 to $60 million dollar loss. This is more the enough money to operate our Montana Highway Patrol for two years, or our annual budget for the Department of Military Affairs that encompasses our National Guard and all state disaster and emergency preparedness expenditures, or all of our annual

institutional and rehabilitation services to persons with disabilities. Other states have reported similar estimates of large revenue losses over time as multistate and multinational companies restructure to take advantage of the tax sheltering opportunities in the legislation.

III. S. 2721 favors large businesses over small businesses and favors out of state corporations over in-state entities, distorts investment decisions and harms economic development efforts especially in rural states.

The planning opportunities presented by S. 2721 are not readily available to just any business; rather, the advantages offered by the bill are most likely not going to be available to small businesses. Those businesses will have to continue paying taxes that their larger competitors will be able to avoid. There is nothing in the bill that specifically limits its protections to larger businesses, but in practical terms, larger businesses will have more opportunities available to them to engage in the tax-planning activities discussed above. For example, a corporation cannot simply establish an affiliate in a low-tax state and assign all of its income to that affiliate; if that were to happen, the original taxing state could disregard the second corporation as a sham. Instead, there must be at least the appearance of a business purpose for setting up that second corporation, and that appearance is more available to larger corporations that will be able to segregate various operations, for example, by having their trademarks put into another entity and then licensed back to the original operating entities. Mom-and-pop operations most likely don't have those options, and most likely don't have the resources to pay for the tax-planning services necessary to develop and implement them.

S. 2721 would allow corporations that can conduct business online or through other remote means to exploit the market in that state with all of the services it may offer and that may also be offered by in-state businesses, and not have to pay that state's corporate taxes, while the in-state businesses must pay the taxes. For example, under this bill, a state would be prevented from taxing an online seller of computers and electronics that separately incorporates its warranty and repair functions as an independent contractor, so long as that independent contractor also contracts with another customer, which could be another affiliated company. The seller would be able to exploit the in-

state market, including providing the support services that are essential to maintaining its market, without being taxable in the state, while in-state sellers would be subject to tax. Or, a bank that has the capacity to offer all of its services online would be able to provide those services to every citizen of a state from outside the state, without opening a branch in that state, and yet never have to pay any corporate taxes to that state. These are just two examples of out of state entities that could leverage economies of scale to exploit a market in a state without being physically present there, while gaining the competitive advantage of not having to pay that state taxes, as the in-state companies that open offices and provide jobs to that state's citizens would have to do. That makes S. 2721 not only patently unfair, but also a strong deterrent to companies considering actually moving into the states, with buildings and jobs, where they conduct their business and derive their profits.

S. 2721 acts as a barrier to the flow of new investment and economic development into states.. As stated by Elizabeth Harchenko, Director of Revenue for the State of Oregon and former Chair of the Multistate Tax Commission:

> In an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[7]

IV. S. 2721 does great harm to our federal system and overturns existing constitutional precedent on state jurisdiction to tax.

S. 2721 runs roughshod over federalism, placing Congress in the position of imposing a federally-mandated jurisdictional standard on all states that will create innumerable opportunities for multistate entities to avoid state taxes. For almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of states to raise revenues from economic activity

[7] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001

occurring within their borders. It has generally refrained from preempting state tax authority except when certain federal interests or the interests of interstate transportation industries (narrowly construed) were involved. With S. 2721, Congress is being asked, without the benefit of any justification or investigative hearings as to the need for such legislation, to overturn the current constitutional "doing business" standard that has governed the imposition of state business activity taxes and replace it with a "physical presence" standard that is not required under current standards and that promotes tax planning and sheltering.

Some proponents of S. 2721 have indicated that the bill merely provides necessary, common-sense clarifications as to what constitutes a physical presence, and that such a bill is needed to clarify what they say is the current state of the law, i.e., that a state may only impose a business activity tax on a business conducting interstate commerce when that business has a physical presence in the state. Such statements, however, are simply not true. Current law does not require a physical presence in the state. This has been made clear by the best source possible, the United States Supreme Court. In *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), a decision affirming that a physical presence is required to satisfy the "substantial nexus" standard for sales and use taxes, the Supreme Court specifically said (twice) that it had never applied the physical-presence standard to other taxes. In addition, S. 2721 would negate U.S. Supreme Court decisions involving attributional nexus through independent contractors, including *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232 (1987), a decision upholding the imposition of Washington's business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor.

The "doing business" standard has been successfully defended in the courts of many states. At last count, courts in at least eight states had upheld the "doing business" standard, and the U.S. Supreme Court had denied *certiorari* in at least two instances

where a state court has upheld the "doing business" standard.[8] S. 2721 would have the effect of reversing these state court decisions. Such encroachment on state tax authority clearly violates the most basic principles of federalism upon which our Nation was built.

Beyond the federalism aspects, the "doing business" standard is a far more appropriate jurisdictional and nexus standard than the physical presence one proposed in S. 2721. It diminishes the ability of businesses to exploit a state's marketplace without incurring tax liability, thus avoiding an adverse impact on smaller, locally-owned businesses. In addition, the doing business standards assures that states have the authority to tax income where it earned.

V. The expansion of P.L. 86-272 is unwarranted and runs counter to the direction that the economy is going.

Public Law 86-272 (15 U.S.C. section 381) prohibits a state from imposing its net income tax on a business whose only activity within the state is the solicitation of orders of tangible property, provided that the orders are approved and the goods are shipped to the purchasers from outside the taxing state. The law was written to respond to complaints from the business community in response to the 1959 Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) that expanded the authority of states to impose nondiscriminatory, fairly apportioned net income taxes on interstate businesses. At the time it was written, Public Law 86-272 was considered as a temporary measure that allowed Congress time to study the issue. The House Judiciary Committee created the Special Subcommittee on State Taxation of

[8] Those court decisions include: Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993); Comptroller of the Treasury v. SYL, Inc., and Comptroller of the Treasury v. Crown Cork & Seal Co. (Delaware), Inc., 825 A.2d 399 (Md. 2003), cert. denied, 124 S.Ct. 961 (2003); A&F Trademark, et al. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004), review denied (N.C., 2005), cert. denied, 126 S.Ct. 353 (2005); General Motors Corp. v. City of Seattle, 25 P.3d 1022 (Wash. Ct. App. 2001), cert. denied, 122 S.Ct. 1915 (2002); Kmart Properties, Inc. v. Taxation and Revenue Dept., No. 21,140 (N.M. Ct. App. 2001), cert. quashed (N.M., 12/29/05); Lanco, Inc. v. Director, Division of Taxation, No. A-3285-03T1 (N.J. Super. Ct. App. Div., 8/24/05); Geoffrey, Inc. v. Oklahoma Tax Commission, No. 99,938 (Okla. Ct. Civ. App., 12/23/05); and, Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. App. Ct. 2000), appeal denied, 731 N.E.2d 762 (Ill. 2000). For further discussion, see Federation of Tax Administrators, "The Current Law Standard of Nexus for Business Activity Taxes," February 23, 2006.

Interstate Commerce also known as the Willis Commission for this purpose. The Willis Commission's report was issued in 1964 but no legislation came from the report and Public Law 86-272 is still on the books.

S. 2721 would expand the scope of P.L. 86-272 by bringing all forms of business activity taxes (not just net income taxes) within its purview and by making all types of sales (i.e., those involving intangibles and services as well as tangible property) subject to its provisions.

P.L. 86-272 in its current limited form is often criticized as providing a tax planning tool to aggressive companies and for lacking any basis in sound tax policy or economic theory. Professor Charles McLure of the Hoover Institution at Stanford University, a noted expert in public finance, in an article in the December 2000 *National Tax Journal*, Professor McLure states:

> "Current rules for determining income tax nexus fail miserably. P.L. 86-272 has been justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income taxes from corporations deriving income from within their borders."[9]

Given its current flaws, it makes no tax policy sense to extend the scope of P.L. 86-272. As technological change enables a growing number of businesses to conduct many of their operations through remote means, expanding P.L. 86-272 will allow more and more businesses to establish and maintain markets in a state without bearing any tax burden in the state. Under an expanded P.L. 86-272, a company could have as many employees in the state for as long as it wanted, driving as many vehicles as it wanted and not be subject to tax as long as the employees confined their activities to solicitation and the goods were shipped into the state from outside (even if in the company's trucks.) An entirely in-state small business would, on the other hand, be taxed on all its activities in the state. This creates unfair competition with in-state businesses and erodes state tax

---

[9] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume LIII, No. 4, Part 3, December 2000, p. 1297.

bases. It seems rather anachronistic to expand P.L. 86-272 in an era when the ability to operate remotely is increasing on a daily basis, and geographic boundaries are relatively meaningless to the manner in which a business operates.

VI. The states have developed an objective, simple bright line nexus standard that makes economic sense, protects small businesses and is understandable by all concerned. The business community has summarily rejected that proposal.

The Multistate Tax Commission's Factor Presence Nexus Standard for Business Activity Taxes[10] (Policy Resolution 02-02) is formulated to provide a "bright-line" standard governing the jurisdiction of states to impose business activity taxes on an enterprise that is doing business in their state. In addition to providing a "bright-line" nexus standard, the factor presence nexus standard would reduce compliance costs for both multistate businesses and state tax administration agencies because the basis of the nexus standard would be based on dollar amounts of sales, payroll, and property -- the factors currently used to apportion a business' net income among the states in which it does business – rather than the myriad "doing business" standards currently used by the states. That is, a multistate state business, not domiciled in a state, would have nexus in that state, if and only if, the level of sales, or payroll, or property (the definition of these factors are contained in the Policy Statement 02-02), exceeded a certain threshold. The threshold levels would relieve businesses from filing income tax returns in states in which they have little economic activity.

The threshold levels in Policy Resolution 02-02 were set at $500,000; and $50,000 for sales, and payroll and property respectively. The threshold level would also be met if the dollar level of any of the factors in that state, relative to that company's total dollar level of the factor were equal to or greater than 25 percent. The dollar threshold levels would be adjusted according to annual changes in the Consumer Price Index published by the U.S. Bureau of Labor Statistics to prevent the real value of the thresholds from the ravages of inflation. To date, only Ohio has formally adopted the

[10] The National Governors Association and the Federation of Tax Administrators do not have specific policy addressing the MTC factor presence nexus standard.

factor presence nexus standard. However, other states are considering this standard for adoption.

The genesis for this nexus standard was based on the discussion of nexus standards set out by Professor McLure, stated his views on proper nexus standards at an MTC seminar on Federalism at Risk and in an article published in the *National Tax Journal*.[11] The principle stated by Professor McLure is:

> "Thus in determining nexus for income tax, it is appropriate to ask whether the potential taxpayer conducts significant amounts of whatever economic activity would give rise to income tax liability if conducted by a profitable taxpayer – that is, whether the taxpayer conducts significant amounts of economic activities that are factors in the state's apportionment formula (e.g., payroll, property, and sales)."
>
> "It would not be satisfactory merely to specify in general terms that significant amounts of in-state property or sales would be required for nexus; that leaves too much uncertainty and too much room for litigation. There should be quantitative bright line tests based on the minimum amounts of each factor needed to establish nexus."

Adoption of a factor-based nexus standard as proposed by the MTC would provide a clear, understandable bright line nexus standard for business activity taxes. The business community has rejected the proposal.

Conclusion

The economy of the 21st Century is electronic and borderless. Most businesses can operate anywhere and anytime without the encumbrance of physical presence. Technological developments have completely reshaped the manner in which business is conducted. Consequently, the business that utilizes modern technology to maximize a state's market may have no less of a presence in the state than the business that establishes a physical presence.

---

[11] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume 53, No.4, Part 3, December 2000, p. 1296.

That is why the current standard of economic presence, taking into account property, sales and payroll, is fair. As Professor Swain points out, "equity is enhanced by economic nexus because economic nexus ensures that similarly situated taxpayers are treated the same, both within each state and nationally."

S. 2721 takes 19th Century tax law and imposes it upon the 21st Century electronic, borderless economy. It replaces economic presence with "headquarters-only" taxation. It is a colonial concept of taxation wherein a company can receive the benefits a state offers without making a fair payment.

How does a multistate company with economic presence in a state receive benefits that state has to offer? It benefits from an enhanced market when a state's residents are educated by a state educational system paid for by state revenues. It benefits when it can adjudicate disputes in a state court system paid for by state revenues. It benefits when its trucks travel on that state's roads with that state's law enforcement officers keeping the road safe to transport that company's goods.

There is no compelling need for federal preemption of state and local law by switching from a system that works to a system that does not work. If change is needed, the states through the MTC factor presence nexus standard have brought forth a better idea.

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to present this testimony. Please do not support S. 2721.