Testimony of

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On the Issue of

State Jurisdiction to Tax Business Activity

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Subcommittee on International Trade

The Honorable Craig Thomas, Chairman

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Mr. Chairman and Members of the Committee, I am Doug Lindholm, President and Executive Director for the Council On State Taxation, which is more commonly known as COST. I appreciate 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 585 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.

In my testimony today, I hope to answer three questions:

- Why does the issue of Business Activity Tax (BAT) nexus warrant Congressional action?
- Why is physical presence the appropriate standard for BAT nexus?
- What impact would a physical presence standard have on State revenues?

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 threshhold 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 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 48 (Accounting for Uncertainty in Income Tax) of its Statement 109 (Accounting for Income Taxes) shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards. FASB Interpretation 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 FASB Interpretation 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 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 FASBI 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 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 that, in order for a State or locality to impose a business activity tax on a business, that 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 both in 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.

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, recently 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."

A Physical Presence Standard Would Minimally Impact State Revenues

COST retained Ernst & Young to estimate the fiscal impact of H.R. 1956, the "Business Activity Tax Simplification Act". [S.2721 is identical to HR 1956.] For all states, the estimated revenue loss is $434 million at the FY 2005 level of current-law state and local business tax collections. The revenue loss is 0.8 percent of the total state and local business activity taxes covered by H.R. 1956 ($54.4 billion), and compared to all state and local taxes paid by business in 2005, the revenue loss is less than one-tenth of one percent (0.1 percent).

Estimates of the fiscal impact of H.R. 1956 have varied widely. Estimating the expected impact of this complex bill on state and local business tax revenues presents revenue estimators with a formidable challenge. They must first determine which specific state and local taxes are affected by the bill and then identify which taxpayers in specific industries will no longer have nexus in a state. The final step is to estimate the change in tax payments for current taxpayers that no longer will be taxable in a state.

The biggest challenge for state revenue estimators is the fact that tax return information for current taxpayers does not provide sufficient information to identify these impacts with any degree of certainty. For example, while estimators may be able to identify taxpayers with no reported payroll and property in a state, there is no information on the return to identify what percentage of firms with "small" factors may no longer have nexus under the bill's de minimis thresholds for physical presence. In addition, in many states only a limited amount of information is actually "captured" in processing returns and available for analysis. Finally, there is no information available from tax returns that can be used to predict short- or long-run restructuring opportunities for taxpayers.

Given these data limitations, both private- and public-sector revenue estimators must make key assumptions in estimating expected revenue impacts. It is understandable that different assumptions and estimating methodologies will result in an unusually wide range of revenue estimates for the bill. The range reflects both the limited amount of information available to estimators and important differences in assumptions about the taxes affected and how taxpayers will respond to the bill.

The very large variation in estimates of the impact of H.R. 1956 reported by CBO, NGA and E&Y is summarized in the table below.

Report	Short-Run Impact	Long-Run Impact
Congressional Budget Office (CBO)	$1 billion	$3 billion
National Governors Association (NGA)	$2.2 to $3.1 billion	$4.7 to $8 billion
Ernst & Young (E&Y)	$434 million	not estimated

The following points may help to understand why there is such a wide range of estimates across and within the studies:

- It is clear from the state survey responses used to prepare the NGA estimates that the states did not agree on their interpretations of the bill's provisions. For example, some states included excise taxes and certain gross receipts taxes that are not affected by H.R. 1956. This is due partly to the fact that the NGA estimates were based on early versions of the bill. The CBO and E&Y studies reflect the latest, amended version of H.R. 1956 that clarifies which taxes and activities are affected.
- The individual state estimates used in the NGA study differ significantly in their estimating methodologies and assumptions. For the states using tax model runs, there is wide variation in the minimum thresholds for payroll and property factors used to eliminate taxpayers assumed to have no physical presence. As a result of these differences, the short-run ("static") NGA tax losses, expressed as a percentage of business activity taxes, ranged from 0.0% to almost 40% for the 29 reporting

states. The CBO and E&Y estimates applied more uniform assumptions and estimating methodologies across the states.

- The impacts of the bill are very sensitive to the composition of industries in a state. However, only a few states in the NGA study estimated the tax impacts industry-by-industry. The E&Y estimates were done on an industry-by-industry, provision-by-provision basis for the 12 selected states.
- The NGA and CBO analyses overstate the *net* short-run revenue loss from H.R. 1956 by not including increased instate activities and income for instate firms, such as independent contractors, that perform functions for firms that would no longer have nexus in a state. In addition, it appears that the NGA estimating methodology did not account for the fact that the majority of separate-filing states have now adopted add-backs of expenses related to the use of intangibles, such as interest and royalty payments paid to out-of-state affiliates. These add-back provisions will reduce any revenue loss from the bill's extension of P.L. 86-272 protections to intangibles.
- A comparison of the short-run and long-run impact figures in the table shows how significant the restructuring assumptions are in the revenue estimates. For CBO, roughly 67 percent of the long-run tax impact is due to restructuring; the comparable figure for NGA is as high as 73 percent. Because there is no information on current tax returns to predict these behavioral changes, these long-run estimates are more speculative than the revenue estimates normally used in the state legislative process.

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. Mr. Chairman, I again thank you for the opportunity to speak before this Committee today. I welcome any questions that you or the Committee members may wish to pose.