Multistate Tax Commission

Statement

of the

Multistate Tax Commission

on

HR 3220

Business Activity Tax Simplification Act

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Subcommittee on Commercial and Administrative Law

on

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I. Introduction

The Multistate Tax Commission is an organization of state governments that works with taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged by this law with:

- Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;
- Avoiding duplicative taxation.

Among the tasks delegated to the Commission is the responsibility to recommend uniform nexus standards for the jurisdiction of states to tax multistate companies. Further, the Compact incorporates the Uniform Division of Income for Tax Purposes which provides specific guidance for how income should be divided among the states. In particular, it establishes a policy standard that the income that is reported to a state should "fairly represent" the business activity in that state. This policy standard is an important benchmark used here to evaluate H.R. 3220.

The Commission was created in 1967 as an effort by states to protect their tax authority in the face of previous proposals to transfer the writing of key features of state tax laws from the state legislatures to Congress. For that reason, the Commission has been a voice for preserving the authority of states to determine their own tax policy within the limits of the U.S. Constitution.

Forty-five States (including the District of Columbia) participate in the Commission, as Compact Members (21), Sovereignty Members (5), Associate Members (16), and Project Members (3).

The Commission is pleased to provide its views on HR 3220, the Business Activity Tax Simplification Act.

II. HR 3220 Unravels the Core Principles of Federalism

HR 3220 would have a profound impact on the principles of federalism and the delicate balance in the federal/state relationship. For over 225 years, Congress has recognized the sovereign authority of states to raise revenue. HR 3220 would destroy this core principle and supplant the authority and judgment of state and local elected officials with the judgment of Congress. HR 3220 would result in shifting the entire burden of funding state and local government onto individual state residents and local businesses that, because of their nature, are unable to take advantage of the myriad of tax planning opportunities established in the legislation. Both local and out-of-state businesses impose social costs on state and local infrastructure and it is entirely reasonable for state legislatures to require all businesses to assume a fair share of the cost of supporting those services. As stated earlier, all states currently share this belief and any action

by Congress to summarily invalidate the laws of these states would do great damage to our federal system of government.

III. The Current Doing Business Standard vs. Proposed Physical Presence: Sales and Profits Do Matter

Corporate income taxes and other business activity taxes have been based from their beginning on the twin concepts of taxing income based on the taxpayer's residence and on where income is earned—its source. Source taxation taxes economic activity that occurs within a state regardless of how that activity is conducted. State corporate income taxes are imposed generally either on the "privilege of conducting business" in the state or on "income earned" within the state. The Supreme Court has made very clear that sales into a state are one of the prime factors for determining that income is earned in that state. Courts have affirmed the application of these taxes to those who are participating in a state's economy whether through physical presence or the use of intangibles such as ownership of stock, trademarks, patents, and the like, or by selling a product into a state even in the absence of any property (tangible or intangible) or people in the state.

By advocating that companies should be taxed only where they have a physical presence, proponents of this concept suggest that sales are not an integral part of income-producing activities. It is conceptually and factually wrong to suggest that companies can derive income (and thus, profits) without making sales. Without a market or customers, no sales can occur, no income is generated and no profits are made.

With respect to multistate companies, states, with the full support and encouragement of the U.S. Supreme Court, have developed over the last eight decades a functional, fair, and equitable system of attributing income among the states in which such companies do business. That system consists of apportioning income—sharing the tax base—through formulas based on real economic activities engaged in by the company: property, payroll and sales. The Supreme Court has been very protective to insure that states do not discriminate against multistate businesses and has also made sure that state taxes are fairly apportioned.

One important goal of the system of income taxation established by the states is to ensure equal treatment between out-of-state companies doing business in a state and local businesses. Ideally, if an out-of-state company and a local business both earn $100,000 of profits from within a state, that amount of income should be taxed equally by the state. This goal of equity is especially important when the two businesses compete directly with each other for the same customers. Unfortunately, H.R. 3220 would result in a large number of cases where the $100,000 profit earned in a state by the out of state company would become effectively exempt from taxation, while the tax burden would continue to fall on the local business.

H.R. 3220 would disrupt the proper functioning of this long standing state income tax system by allowing companies to artificially shift income away from where a company is earning the income to tax haven locations. H.R. 3220 establishes a system of "headquarters only" taxation that is directly counter to the system of sharing the tax base among the states where real economic activity is occurring. A "headquarters only" system is a colonial concept of taxation

that allows companies to earn income and benefit from the services of other jurisdictions, but does not ask them to make a fair payment for the use of those public services.

H.R. 3220 purports merely to simplify tax rules by establishing a bright line nexus standard. This characterization is wrong on many counts. The legislation does not establish a bright line of physical presence but contains many exceptions where even taxpayers that have clear and substantial physical presence would be protected by the legislation from paying tax on the income they earn in a state. Moreover, physical presence is inevitably an unworkable standard as all the litigation that has followed from the *Quill Corp. v. North Dakota* decision has shown. Fundamentally, even remote businesses find they need to have contacts in a state to service their customers or to protect their interests. Businesses use sales representatives in states to increase sales. They hire attorneys to sue customers who have not paid. They send in employees or agents to perform installation or warranty work. The supposed “abuse” cited by the Smithfield Farms witness at the hearing was really an indictment of P.L. 86-272, not of the New Jersey tax agency. The company clearly had a physical presence in New Jersey when it was stopped for tax purposes. The company argued that its activities were limited to those protected by P.L. 86-272, but that could not be determined except after the fact. The dispute in that instant was a precursor to expanded disputes that would occur under H.R. 3220, where a company would for all outward appearances have a physical presence, but would claim that it was exempt under the numerous provisions purportedly defining physical presence. In other words, a bright line physical presence would not necessarily be a physical presence under the bill. How is a tax agency supposed to determine that a physical presence exists? Physical presence can also be hidden and manipulated by less responsible taxpayers in ways that invite abuse. It is not easy for state tax agencies to discover physical presence. Thus, in practice, a physical presence standard leads not to equitable certainty in the application of the law, but to uneven and uncertain tax results: some companies will be discovered and too many others will be hidden.

It is disingenuous to pretend that market states provide nothing to businesses that make sales there. An educated, financially prosperous, secure market is essential for a business to prosper. Recent studies have shown that spending for higher quality schooling adds to the growth rate of Gross Domestic Product (GDP). State and local taxes pay for more than 90 percent of the costs of the education of its citizens. Clearly, this spending provides a direct benefit to companies making sales into a state, because higher incomes generated by educational investments yield higher sales and profits for those companies. Furthermore, states and local governments provide court systems that give remote sellers confidence to sell to consumers in other states knowing they can get recourse in courts in the customers’ states and give customers the confidence to buy from remote sellers because the customers know they can get recourse in their own courts against the remote sellers. Finally, state and local governments provide roads and police and fire protection that ensure that the goods purchased from remote sellers will arrive safely.

The argument that companies selling into a state without a physical presence do not receive the benefits of public services from the market state is simply wrong. In analyzing the “no benefits without a physical presence argument,” noted tax experts Walter Hellerstein and Charles McLure have stated:

> This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible.[1]

H.R. 3220 disrupts source taxation by preempting states from taxing companies that do business in or earn income from within a state, regardless of whether or not they have physical presence. However, even a company with major physical presence in a state can still shift income away from that state. Under HR 3220, a company can create a subsidiary to hold intangibles such as its trademarks that are then licensed to the in-state stores. A company can have a significant number of employees in a state earning income and assign those employees to an out-of-state subsidiary to avoid taxation. A company could even have a building located in a state, but benefit from tax-planning opportunities in the legislation to avoid state taxes. These are just a few examples of physical presence that would be shielded from taxation under HR 3220 that would allow most, if not all, businesses to escape taxation.

HR 3220 would overturn well-developed law in many states which recognizes that a business that utilizes new technologies to exploit a state's market has no less presence in the state than a local business. Indeed, if presence is measured by sales an out-of-state company may well have a greater presence in a state's economy than a large number of small, local businesses including those with which it directly competes. The legislation would preempt state jurisdiction to tax based on the use of intangible property in a state or sales made into a state. Both out-of-state and local businesses benefit from and impose costs on state services such as education, commercial laws, the state judicial system, and police protections, for which each business should pay its fair share. To exempt remote business from the obligation to contribute to the infrastructures and place the entire burden on local businesses would allow remote businesses to earn significant income in a state without making any contribution toward state services it receives or costs it imposes on a state.

IV. Tax Policy Considerations

a. HR 3220 promotes tax sheltering that would shift the tax burden unfairly to local businesses. HR 3220 is bad tax policy—it is neither simple, efficient or equitable. It would legitimize tax sheltering strategies that some multistate businesses use to shift income artificially out of the state where it was earned to a state or foreign country that does not tax that income.[2] Indeed, it will even require public companies that currently disdain tax sheltering to shift income in this manner because of the fiduciary duty of the company's officers to shareholders to reduce the company's tax liability. The result will be that multistate companies

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[1] Charles E. McLure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals, *State Tax Notes*, March 1, 2004.

[2] In plain terms, "tax sheltering" for state tax purposes means here that income is not being reported in proportion to the business activity in the state that gave rise to the income. Instead, the income is being shifted to other locations. Tax sheltering may or may not be technically legal in various instances, but all tax sheltering falls short of the policy standard of the Uniform Division for Tax Purposes Act that income should be reported to states so that it "fairly represents" where the business activity giving rise to that income occurs. Tax sheltering is to be distinguished from legitimate tax planning which involves changing real business activity—the location of jobs, facilities or sales—among states to take advantage of lower tax rates.

would secure a tax reduction to the disadvantage of purely local businesses. The Congressional Research Service recognized this failing of HR 3220 in its recent analysis stating: "The new regulations as proposed in H.R. 3220 could exacerbate 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 also expands the opportunities for tax planning and thus tax avoidance and possible evasion."[3]

b. HR 3220 would have the effect of stifling economic development. HR 3220 creates a number of winners but also many losers in the business world. Some corporations could escape tax liability in every state where it does business except in the state of the corporation's domicile. The result is that more of the tax burden is shifted onto small businesses with few resources and local businesses which will almost certainly reduce—or even eliminate—their ability to compete in the marketplace. Most importantly, HR 3220 could freeze economic development in place as more and more businesses seek to minimize their physical presence in a taxing jurisdiction. If a physical presence standard were established, companies would have a disincentive to move jobs and investments into states where they have customers. Under a physical presence regime, a company making investments in a state into which they market would suddenly face a new business tax liability. Under the existing "doing business" standard, the company should already be paying income taxes to that state. A physical presence standard would have the ironic and highly negative economic effect of inhibiting the free flow of investment across state boundaries.

c. HR 3220 adds complexity to state tax laws and insures years of litigation. Supporters of HR 3220 claim the legislation's physical presence requirement establishes a "bright line" for determining whether a business does or does not have nexus with a state. Certain provisions in the proposed legislation belie this assertion—they are neither a physical presence test nor a bright line test. Rather, HR 3220 contains a myriad of provisions that would allow businesses to establish a physical presence in a state and yet escape business activity tax liability altogether.

Examples of the inequities created by the legislation abound. The physical presence exception granted to businesses engaged in gathering news and event coverage is illustrative. This provision would allow an out-of-state news organization to locate substantial amounts of real and tangible property and employees in a state yet escape business activity tax liability. This is unfair to in-state taxpayers and also other out-of-state taxpayers who would remain subject to a state's business activity tax solely as the result of engaging in a type of business which would not be protected by HR 3220.

H.R. 3220's requirement that a business be physically present in a state in order to be subject to business activity taxes allows companies to shift income earned in a jurisdiction where they are physically present to a jurisdiction that imposes no business activity tax. A company could set up a subsidiary holding company in a no-tax state, and transfer ownership of its intangible assets-

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[3] Congressional Research Service,"State Corporate Income Taxes: A Description and Analysis", March 23, 2004, p. 14.

trademarks, patents and the like-to its subsidiary. The subsidiary then licenses the use of such intangibles back to the parent, for which it receives royalties from the parent company. The parent continues to do business in states where it has both a physical presence and sales, but the income earned is shifted out of the state in the form of royalties to the subsidiary holding company.

The interplay between sections of the legislation excepting certain activities in a state from the physical presence rule and those excepting certain kinds of tangible property present in a state is also unfair to businesses that do not participate in such activities, or that own property for different purposes than that allowed by the exception.

For example, the exception to the physical presence rule allowing the presence of employees in a state who meet with government officials for purposes other than selling goods or services permits that out-of-state company to own substantial property as long as that property is used to meet with government officials. A lobbying concern could own retreat facilities, conference facilities or even a condominium for use by the employees when they visit a state to lobby.

The nexus exception pertaining to the presence of tangible property owned by a nonresident company located in a state for purposes of being manufactured, assembled and the like is also unfair to other out-of-state businesses that own similar property that is present in a state for different reasons. A nonresident company could own millions of dollars of property in the form of hazardous materials, machinery components, etc. in a state, which imposes a significant cost to the state in the form of services the state provides, such as police and fire protection. Yet, under this provision, that company escapes paying its fair share of a portion of the service the state renders.

HR 3220 is bad tax policy because it violates a major canon of good tax policy articulated by Adam Smith more than 225 years ago—tax neutrality—taxes should interfere as little as possible with business decisions. H.R. 3220 violates this important principle by influencing the way a business organizes itself and influencing a firm's choice of location. H.R. 3220 subsidizes the activities of out-of-state businesses and shifts a greater burden of taxation onto local businesses and individual taxpayers.

V. <u>HR 3220 Would Overrule Tax Laws in Virtually Every State Based on Economic Activity</u>

HR 3220 would overrule state and local laws currently in effect in virtually every state. HR 3220 applies not only to the corporate income tax, but to other business activity taxes such as public utility gross receipts taxes and gross receipts taxes such as the Washington State Business and Occupations Tax. With a very few exceptions, most states and localities impose at least one business activity tax as a result of economic activity irrespective of whether the company has a physical presence. For example, Maryland imposes its corporate income tax to the full extent allowed by the U.S. Constitution. Nexus exists in New Mexico when a corporation transacts business in or into New Mexico or has a corporate franchise in the state. In South Carolina, every C corporation doing business in the state is subject to the corporate income tax. "Doing business" is defined as the operation of any business enterprise or activity in South Carolina for

economic gain. Maryland, South Carolina, and New Mexico have successfully defended their economic presence nexus standard against Commerce Clause challenges in their state court systems; the United States Supreme Court has denied review of the Maryland and South Carolina cases. HR 3220 would statutorily overrule both the state tax statutes in these states and the judicial decisions that have sustained the statutes against constitutional challenge. Congress should respect the considered judgment of state legislatures and courts and not impose such an ill-advised jurisdictional requirement on the states.

VI. **Possible Solutions**

In context, HR 3220 is an overreaching proposal that seeks to resolve an issue absent consideration of fact, analysis, or current law. While businesses have provided several limited examples of controversy with state revenue departments, revenue commissioners have reported few current instances of taxpayer complaints relating to assessment of business activity taxes. Regardless of the perceived extent of the problem, finding a solution to the problem—if one is needed—is a matter best left to states and businesses themselves.

There is ample recent history of states and businesses working together to find solutions to tax and non-tax issues. In 2001, states, local governments, and the telecommunications industry successfully completed negotiations to formulate sourcing rules for mobile telecommunications services. These rules have now been adopted by more than 30 states and ratified by Congress. Similarly, states, local governments, and businesses are in the midst of a multi-year cooperative effort to modernize, streamline, and simplify state and local sales tax laws as a part of the Streamlined Sales Tax Project. Once completed, this effort will result in administrative cost savings to both sellers and states and provide a mechanism to insure a level playing field among all sellers in the marketplace. Similarly, rulemaking—on tax and non-tax issues--undertaken by states involves substantial input and consultation with the business community.

The sourcing and sales tax projects are examples of specialized, highly technical areas of state tax law that challenged states and businesses in negotiating solutions that resulted in fairness and equity to all parties. Any attempt to revise current state business activity tax laws commands the same consideration. As business operations evolve and recognizing the needs of both states and the business community for continual refinement in the business activity tax area, the Commission has already developed a proposal for consideration. In 2002, the Commission adopted Policy Statement 02-02, which sets forth the Commission's views on the economic presence standard for imposition of business activity taxes. Policy Statement 02-02 also includes the Commission's Factor Presence Nexus Standard for Business Activity Taxes, which bases a company's liability for business activity taxes on a threshold amount of a company's property, payroll, or sales in a state. The Factor Presence Standard is a fair, balanced approach to imposition of business activity taxes that provides equity between in-state and out-of-state businesses while eliminating instances of double taxation or instances where businesses may be assessed tax for minor amounts of presence in a state. This standard would also make it clear, readily apparent and certain to both companies and tax agencies when a company would have nexus with a state—thus producing greater equity and uniformity in the actual application of the tax law to different businesses. In addition, the Commission has offered to initiate discussions between states and businesses, the goal of which would be to find common ground on simple,

clear, uniform nexus standard for business activity taxes. Thus far, the business community has been reluctant to engage in these discussions.

Ultimately, a cooperative effort by both states and businesses—one that includes a thorough analysis of current business activity tax nexus statutes as well as controversies that have arisen between businesses and states—is the best method for maintaining viable state tax systems.

We hope this information is helpful to the Subcommittee and its staff during its ongoing consideration of HR 3220. The Commission would welcome the opportunity to answer any questions that Subcommittee Members and staff may have.