To:	Executive Committee
From:	Sheldon Laskin, MTC Counsel
Date:	November 30, 2012
Subject:	HR 1439, Business Activity Tax Simplification Act 2011

The purpose of this memo is to summarize the major provisions of HR 1439, the Business Activity Tax Simplification Act (hereinafter, "BATSA") of 2011.

Background

In 1959, in response to business concerns that the states were asserting an overly expansive view of their jurisdiction under the Commerce Clause to impose a net income tax on the income of multistate businesses, Congress enacted PL 86-272. The statute was a response to the decision of the United States Supreme Court in *Northwestern States Portland Cement v. Minnesota*, 358 U.S. 450 (1959), which upheld the imposition of an income tax imposed on a corporation conducting a purely interstate business in manufacturing and selling tangible personal property. [1] Although intended as a temporary measure until Congress studied and addressed state taxation of multistate businesses, the statute has never been repealed.

Briefly, PL 86-272 bars a state (other than the state of commercial domicile) from imposing a tax on or measured by net income on a business if the only activity in which that business engages in the taxing state consists of solicitation of sales of tangible personal property, provided that the sale orders are accepted and filled from a point outside the state. If the sales activity is engaged in by a non-employee representative of the business (the representative must represent one other principal that is independent of the business), the representative can also engage in actual sales and can maintain an office in the taxing state without exceeding the protections of the safe harbor.

[1] Although Northwestern Portland Cement in fact had facilities in Minnesota, the concern was that the states could extend its holding to remote businesses solely on the basis of sales solicitations in the taxing state.

In recent years, the business community has repeatedly introduced previous versions of BATSA in Congress, which would extend the provisions of PL 86 -272 in the following ways.

1. The statute would apply to a broad range of business activity taxes in addition to those imposed on or measured by net income.
2. The statute would apply to the provision of services and intangibles as well as to the solicitation of sales of tangible personal property.
3. The statute would create a physical presence "safe harbor" whereby the business could enter the state for 15 days per year without being subjected to a state's authority to impose business activity tax.
4. Notwithstanding the 15 day jurisdictional limit, the statute would allow a business to be present in the state for an unspecified period of time in excess of 15 days, as long as its presence in the state was "limited" or "transient."
5. The statute would allow the business to exceed the threshold safe harbor for specified activities, without any annual durational limitation.

The most recent iteration of BATSA Is HR 1439. HR 1439 was introduced in the House on April 8, 2011, by Representatives Robert Goodlatte (R-VA), Robert Scott (D-VA) Jeff Duncan (R-SC) and Sheila Jackson Lee (D-TX). It was reported out of the House Judiciary Committee by voice vote on July 7, 2011. There are currently 12 sponsors of the bill. The remainder of this memo will summarize the key provisions of HR 1439.[2]

<u>Section 2 (Modernization of Public Law 86-272)</u>

Section 2 of the bill creates various safe harbors from tax, irrespective of how long the business is physically present within the taxing state in any year.

Section 2 would allow a business to furnish information to a customer, an affiliate or an independent contractor in the State, if that information were ancillary to the solicitation of orders or transactions by or on behalf of the business. This provision would appear to allow businesses to engage in consulting services within the state without becoming subject to tax. In addition, the business could engage in gathering information within the state without exceeding the protection of the statute, as long as the information gathered is disseminated from a point outside the state. There is a similar provision for coverage of events. These two provisions appear to allow news, entertainment and sports journalists to cover events within the state without incurring tax liability for income realized from sources within the state.

In addition, Section 2 allows the business to engage in business activities directly related to the potential or actual purchase of goods or services within the state without exceeding the safe

[2] Attached hereto is a copy of HR 1439. In addition, because Section 2 of the bill amends PL 86-272 by interlineation, staff has prepared a red-lined copy of how the statute would read if Section 2 were incorporated into the current statute. Sections 3 through 5 of the bill consist of new language, not added by interlineation of the existing statute.

harbor, as long as the final decision to purchase is made outside the state. This could allow the company to station purchasing agents in the state on a permanent basis without creating jurisdiction for the state to tax the company's business activities, as long as the actual purchasing decision was made outside the state.

PL 86-272 currently limits a state's authority to impose a net income tax for any taxable year ending after September 14, 1959. PL 86-272, Section 101. HR 1439 retains the language of Section 101. However, Section 2 of HR 1439 proposes to amend Title I of PL 86-272 by adding a new Section 105, which would read;

> For taxable periods beginning on or after January 1, 2012, the prohibitions of section 101 that apply with respect to net income taxes shall also apply with respect to each other business activity tax, as defined in Section 5(a)(2)….[3]

Notwithstanding the language of Section 105, the original language of Section 101 ("any taxable year ending after September 14, 1959") is retained in the statute. This retention appears to be unnecessary in light of Section 105. At the very least, the references to 1959 and net income taxes in Section 101 should be deleted as unnecessary.

Section 3 (Minimum Jurisdictional Standard for State and Local Net Income Taxes and Other Business Activity Taxes)

In addition to the activity related safe harbors of Section 2, Section 3 creates several durational safe harbors that apply generally irrespective of the nature of the activities in which the company engages.

Section 3(b)(2)(A) purports to establish a de minimis annual 15 day physical presence standard for a state to impose a business activity tax. While this is a slight improvement over the previous standard of 21 days contained in earlier BATSA bills, a federal mandate barring a state to impose tax based on an arbitrary minimum threshold of physical presence goes beyond Quill (which set no fixed minimum standard for establishing the requisite physical presence), is an unwarranted preemption of a state's sovereign power to determine what, if any, de minimis standards are reasonable in the context of that state's economy, and ignores the nature of the US service-based economy which allows a business to generate substantial income, year after year, while maintaining very limited physical presence in any one state.

Furthermore, it is clear from Section 3(b)(2)(B) that the proposed 15 day de minimis physical presence rule in fact would establish no such physical presence floor. Section 3(b)(2)(B) sets forth an **additional** de minimis threshold. Even if the 15 day threshold were continuously exceeded, section 3(b)(2)(B) would nonetheless bar a state from imposing tax if the business were only present in the state "to conduct limited or transient business activity." Neither

[3] The effective date of HR 1439 as a whole is also January 1, 2012. Section 5(b).

"limited" nor "transient" are defined in the bill. "Limited" is defined as "confined or restricted within certain limits."[4] "Transient" is defined as "remaining in a place only a brief time."

Unlike the 15 day rule – which at least has the virtue of setting an objective standard – the terms "limited" and "transient", when used to measure the scope of business activity necessary to allow a state to tax, are totally subjective concepts. What are the "certain limits" within which business activity must be "confined or restricted" in order to be considered "limited?" What standards should tax administrators, taxpayers and the courts use to evaluate whether business activity has exceeded those standards? How briefly must business activity continue in a place to be regarded as transient? In light of the 15 day rule, it must necessarily be the case that the "transient activity" safe harbor must **exceed** the 15 day floor, or it would be superfluous. If so, there is in fact no 15 day floor. And if that is the case, far from establishing a firm minimum physical presence standard, the bill is likely to only increase uncertainty for tax administrators and taxpayers alike and to lead to increased nexus litigation to define these terms.

Furthermore, it is clear from Sec. 3 (b)(2)(d) that not even the amorphous "limited or transient business activity" standard establishes a true floor for the physical presence safe harbor that would be created by HR 1439. Sec. 3(b)(2)(d) allows "a State or any other provision of Federal law" to allow persons to conduct greater activity without the imposition of tax jurisdiction. Significantly, this provision does not appear to be limited to the authority of state *legislatures* to establish higher minimum jurisdictional standards than those allowed by the bill; it would hardly be necessary for Congress to authorize state legislatures to enact standards that are *more* restrictive than the minimums established by federal law.[5] Therefore, this provision appears to authorize state *courts* to establish higher jurisdictional thresholds than those provided by HR 1439. The language, at the very least, could enable taxpayers to argue to state judges that Congress contemplated that they would have the authority to set more restrictive jurisdictional standards, even in the absence of state de minimis statutes. Should HR 1439 become law, the states might not even have the certainty of knowing that the statute had established a uniform jurisdictional threshold for business activity above which the states could impose tax liability. Under Sec. 3(b)(2)(d), taxpayers could always litigate an assessment in state court, seeking to raise the floor supposedly established by the statute. This creates a real zero sum game for the states – heads they lose, tails taxpayer wins.

Finally, Sec. 3(b)(1)(B) would allow a business to use the services of an agent in the state on an unlimited basis without exceeding the safe harbor, as long as the agent performs services in the

[4] The definitions of "limited" and "transient' contained herein are taken from the American Heritage College Dictionary, 3d Edition.

[5] In addition, the grammatical structure of this provision supports an interpretation that the term "a State" is not necessarily limited to a state legislature. If the intention was to make clear that state legislatures could establish a higher jurisdictional threshold, a more logical grammatical construction would be to say that the statute should not be construed to preempt any State or federal law that sets such a higher standard. The grammatical construction used in the bill does not necessarily require the term "a State" to modify "law."

State for any other person during the taxable year. There is no requirement that the "other person" not be legally affiliated with the taxpayer. Therefore, a corporation could have an affiliated agent continuously perform services in the state on behalf of multiple affiliates without ever exceeding the protections of the safe harbor.

Section 4 (Group Returns)

Section 4 is not a minimum jurisdictional provision at all; it is an apportionment statute. Section 4 requires any state using combined reporting to include the factors of all members of the combined group in the denominator of the apportionment formula while barring the state from including the factors of any member of the combined group whose activities in the state do not exceed the minimum jurisdictional threshold – which under Sec. 3(b)(2)(d) can always be subject to dispute – in the numerator. In effect, this provision codifies the Geoffrey throwback rule and precludes a state from applying the Finnegan rule instead.

Section 5 (Definitions and Effective Date)

It is not clear whether a property tax would be considered an "other business activity tax" under the bill. Sec. 5(a)(2)(A) defines an "other business activity tax" to include a tax "measured by the amount of, or economic results of, business or related activity conducted in the State." Sec. 5(a)(2) (B) excludes a sales tax, a use tax, or a similar tax, from the definition of an "other business activity tax." Many states impose a personal property tax on tangible personal property used in a business. An argument can be made that such a tax is "measured by the amount of, or economic results of, business or related activity conducted in the state" precisely because the tax is imposed on property used in a business. At the least, this item requires clarification.

Sec. 381. Imposition of net income tax

(a) Minimum standards

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are ~~either, or both,~~ any one or more of the following:

(1) the solicitation of orders ~~by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and~~ (which are sent outside the State for approval or rejection) or customers by such person, or his representative, in such State for sales or transactions, which are –

(A) in the case of tangible personal property, filled by shipment or delivery from a point outside the State; and

~~(A)~~ (B) in the case of all other forms of property, services, and other transactions, fulfilled or distributed from a point outside the State;

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1);

(3) the furnishing of information to customers or affiliates in such State, or the coverage of events or other gathering of information in such State by such person, or his representative, which information is used or disseminated from a point outside the State; and

(4) those business activities directly related to such person's potential or actual purchase of goods or services within the State if the final decision to purchase is made outside the State.~~.~~

(b) Domestic corporations; persons domiciled in or residents of a State

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to -

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during a taxable year merely –

(1) by reason of sales or transactions in such State, the solicitation of orders for sales or transactions in such State, the furnishing of information to customers or affiliates in such State, or the coverage of events or other gathering of information in such State, on behalf of such person by one or more independent contractors;

(2) by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State are limited to making sales or soliciting order for sales or

Comment [SHL1]: Current Section 381(b) appears to be redundant in light of the proposed exception for such taxpayers contained in Section 3(e)(1) of HR 1439. Nevertheless, no provision of HR 1439 purports to repeal or amend current Section 381(b) so I did not strike it from this document.

transactions, the furnishing of information to customers or affiliates, and/or the coverage of events or other gathering of information; or

(3) by reason of the furnishing of information to an independent contractor by such person ancillary to the solicitation of orders or transactions by the independent contractor on behalf of such person.

~~(c) Sales or solicitation of orders for sales by independent contractors~~

~~For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, or tangible personal property.~~

(d) Definitions

For purposes of this section -

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling or fulfilling transactions, or soliciting orders for ~~the sale of, tangible personal property~~ a sale or transaction, furnishing information, or covering events, or otherwise gathering information. for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.