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April 13, 2011

VIA EMAIL

The Honorable Howard Coble, Chairman
The Honorable Steve Cohen, Ranking Member
Subcommittee on the Courts, Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives
517 Cannon House Office Building
Washington, DC 20515

Re: Hearing on H.R. 1439, the "Business Activity Simplification Act of 2011"

Dear Chairman Coble and Ranking Member Cohen:

Thank you for the opportunity to submit this statement for the record for the April 13, 2011 hearing on H.R. 1439 on behalf of the Council On State Taxation (COST). COST strongly supports H.R. 1439 and encourages you to move it swiftly through the Subcommittee.

About COST

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 nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multistate business entities.

BAT Nexus Needs Congressional Action

Our comments address two fundamental questions at hand:

1. Why does the issue of Business Activity Tax (BAT) nexus warrant Congressional action?
2. Why is physical presence the appropriate standard for BAT nexus?

The first, and perhaps the 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. That is, does the business have "nexus" with the state? The threshold is governed by the United States 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 be subject to taxation by a state or municipal jurisdiction.

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 state's tax without creating an impermissible burden on interstate commerce. In the Court's 1992 *Quill* decision, *Bellas Hess* was reaffirmed and the Court retained 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 a 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, stating: "[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 absence of Congressional action following the Court's decision, states (and municipalities) have become increasingly aggressive in attempting to assert tax jurisdiction over interstate commerce. These efforts to reach companies with minimal or no physical presence in a state have led to litigation in state courts with mixed results – not unexpected given the lack of clear guidance from either Congress or the United States 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 efforts by the states 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 concern regarding state tax policy.

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 continue to increase the costs and risks of operating a multistate business in the future. For example, the Financial Accounting Standards Board Accounting Standards Codification 740-10 ("ASC 740-10") of its Statement 109 (Accounting for Income Taxes) shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards. ASC 740-10 appropriately seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes.

Unfortunately, the lack of any definitive, national authority for state tax jurisdiction complicates the analysis under ASC 740-10 and creates an ongoing dilemma for multistate companies. For example, 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 may never expire. 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 ASC 740-10. As a result, this phantom tax liability imposed by the state (plus accrued phantom penalties and interest) will never disappear from the financial statements unless the business is actually audited and the state determines that in fact, it does have nexus. This is but one example of how current uncertainty over the scope of the nexus requirement creates confusion beyond the immediate and apparent tax effects.

Congress, accordingly, with plenary authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but also 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, in order for a state or municipality to impose business activity tax on an entity, that a 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.

Determination of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens – economic and 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 benefits or protections from the jurisdiction, should not be required to pay tax to that jurisdiction. Such a test also delineates a clear line to guide both businesses and the states (including their localities) on when a business can be subject to a State's tax.

Congress must exercise its authority under the Commerce Clause to recognize physical presence as the nexus standard for business activity taxes. In doing so, Congress should include a *de minimis* threshold 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 the 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 the burdens on business that a lower threshold would invite the global economy in which we now live. In prior testimony before the Senate, the Multistate Tax Commission (MTC) 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 party, recognizes such a low threshold for tax jurisdiction. This raises further questions: What is economic nexus? Is it where a business has a customer? A website? An account receivable? 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 MTC Executive Director, Eugene Corrigan, has 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 efforts via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best."

Conclusion

In 1992, the Supreme Court invited Congress to legislate in the arena of nexus. Nearly twenty years later there has yet to be Congressional action on this matter. Once again, in 2011, Congress has the opportunity to properly construct a bright-line physical presence nexus standard that will promote fairness, eliminate uncertainty for both the business community and states, and significantly reduce the frequency and costs of litigation. Toward that end, COST respectfully requests swift and favorable action on H.R. 1439.

Sincerely,

Joseph R. Crosby

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cc: COST Board of Directors
Douglas L. Lindholm, President & Executive Director, COST