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REPORT
112–257

BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2011

OCTOBER 21, 2011.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. SMITH of Texas, from the Committee on the Judiciary, submitted the following

R E P O R T

together with

DISSENTING VIEWS

[To accompany H.R. 1439]

[Including cost estimate of the Congressional Budget Office]

The Committee on the Judiciary, to whom was referred the bill (H.R. 1439) to regulate certain State taxation of interstate commerce, and for other purposes, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

CONTENTS

Purpose and Summary

The Constitution prohibits a state from imposing any tax on a taxpayer that lacks a "substantial nexus" with the state.[1] What constitutes a "substantial nexus" with respect to a state's ability to impose net income or other business activity taxes (collectively, "BATs") upon a business, however, is unclear.[2] If read narrowly, the Supreme Court's 1992 decision in *Quill Corp. v. North Dakota,* which requires physical presence in the state to satisfy a substantial nexus, applies only to a state's imposition of sales and use tax collection and remittance requirements upon taxpayers.[3] Many states do read *Quill* narrowly and impose net income and other BATs on businesses that lack a physical presence and have a mere "economic presence" in the state.

States lack a uniform definition for "substantial nexus" for BATs. The patchwork of tests to determine whether a business has "economic presence" in a state leads to considerable uncertainty for businesses attempting to estimate and reserve capital for their tax liability.[4] At the *2011 Hearing,* the Subcommittee on Courts, Commercial and Administrative Law heard testimony from a franchisor from Richmond, Virginia, who suggested that small businesses face the choice of either engaging a tax advisor at great cost to determine where the business has a nexus, or waiting until a tax questionnaire or tax bill appears on the business's doorstep:

> As a franchisor, I have very little visibility on what the nexus rules are in each state and when they change and why they change. . . . For a small business like mine, managing this issue is rife with uncertainty created by this environment. I could proactively engage another tax advisor and have them go seek out all the 34 states where I have franchisees and determine which ones would have nexus with me. . . . I could be passive, which is what I think most franchisors in my situation do, where we wait for the next franchise activity questionnaire to come in and we respond to it accordingly.[5]

H.R. 1439, the Business Activity Tax Simplification Act of 2011 (BATSA), reduces the kind of tax uncertainty Mr. Schroeder described by confirming that *Quill*'s bright-line "physical presence" standard applies to a state's imposition of BATs.[6]

BATSA has three primary legislative features. First, it establishes a bright-line physical presence nexus requirement in order

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[1] *See Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 277–78 (1977) (requiring a "substantial nexus" for constitutional state taxation of interstate commerce).

[2] *See generally Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. (2011) [hereinafter *2011 Hearing*]; *State Taxation: The Role of Congress in Defining Nexus: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 111th Cong. (2010); *Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 110th Cong. (2008); *Business Activity Tax Simplification Act of 2005: Hearing on H.R. 1956 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 109th Cong. (2005); *Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 108th Cong. (2004) [hereinafter *2004 Hearing*].

[3] *See Quill Corp. v. North Dakota,* 504 U.S. 298, 317–18 (1992).

[4] *See 2011 Hearing, supra* note 2, at 26–36 (testimony of Corey Schroeder, Vice Pres. and CFO, Outdoor Living Brands, Inc., on behalf of Int'l Franchise Ass'n).

[5] *Id.* at 27.

[6] *See* Business Activity Tax Simplification Act of 2011, H.R. 1439, 111th Cong. (2011).

for states to impose or collect net income taxes or other BATs on multistate enterprises. Second, BATSA updates Public Law 86–272, enacted in 1959 to prohibit states from imposing taxes on the net income of interstate sellers of tangible personal property if the only business activity within the state consists of the solicitation of certain sales orders, so that the law applies equally to intangible goods and services. Finally, it restricts the means by which a state may apportion the income of a unitary group of affiliated businesses so that only that portion of the business activity conducted in a state may be taxed by that state. As secondary matters, the bill also lists conditions that a business must satisfy in order to be considered physically present for nexus purposes and clarifies that each person in a group of affiliated businesses has legal separateness so that physical presence may not be imputed.

Background and Need for the Legislation

I. INTRODUCTION

On Friday, April 8, 2011, Mr. Goodlatte (R–VA) introduced, along with Mr. Scott (D–VA), Mr. Duncan (R–SC) and Ms. Jackson Lee (D–TX), H.R. 1439, the "Business Activity Tax Simplification Act of 2011." BATSA is substantially similar to its predecessors that were introduced in prior Congresses.[7]

BATSA expands Public Law 86–272, an existing Federal prohibition against certain state taxation of interstate commerce, to include taxation of out-of-state transactions involving all forms of property, including intangible personal property and services.[8] Currently, that prohibition applies only with respect to taxes on sales of tangible personal property. BATSA also clarifies that the U.S. Constitution prohibits state assessment of BATs on an out-of-state entity unless such entity has a physical presence in the taxing state and sets forth criteria for determining whether an entity has a physical presence in a state.

II. LIMITATIONS ON STATE TAXING AUTHORITY

Most state taxes fall into four broad categories: taxes on property; income and other BATs; general and selective sales and use taxes; and licenses, fees, and miscellaneous taxes. As sovereign governments, states are generally free to use their tax codes to collect revenue and encourage or discourage certain behaviors. For example, states with robust tourism industries, such as Florida and Nevada, impose high sales taxes because of the volume of transactions that occur within their borders. Other states, like New Hampshire, have decided to impose high property taxes relative to other states but, in order to attract population and commerce, do not impose taxes on earned income or sales.[9]

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[7] *Compare* H.R. 1439, *with* Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009); Business Activity Tax Simplification Act of 2008, H.R. 5267, 110th Cong. (2008); Business Activity Tax Simplification Act of 2006, H.R. 1956, 109th Cong. (2006); Business Activity Tax Simplification Act of 2003, H.R. 3220, 108th Cong. (2003).

[8] The Committee takes the position that the holding of *Quill* applies to all taxes imposed by a state, including BATs.

[9] For a summary of current state tax laws and rates, *see* Ryan Forster and Kail Padgitt, *Where Do State and Local Governments Get Their Tax Revenue?*, THE TAX FOUNDATION FISCAL FACT NO. 242 (August 2010), http://www.taxfoundation.org/files/ff242.pdf.

While a state's authority to set its own tax policy is broad, it is not plenary. The Supreme Court has inferred from the grant of power to Congress in the Commerce Clause that state and local laws are unconstitutional if they place an undue burden on interstate commerce—a principle commonly known as the "dormant" commerce clause.[10] The Due Process Clause of the 14th Amendment also constrains a state's taxing ability.[11] An out-of-state business must have a nexus under both the Due Process Clause and the Commerce Clause before a state may impose a tax on that business. While the Due Process Clause requires only a minimum connection between the putative taxpayer and the taxing state, the U.S. Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus" between the two.[12]

The modern, generally applicable test for determining whether a state tax impermissibly burdens interstate commerce was set forth by the Supreme Court in 1977 in *Complete Auto Transit, Inc. v. Brady.*[13] Prior to that decision, the Court employed an approach that scrutinized whether the tax "directly" or "indirectly" taxed interstate commerce, a rubric that varied from the test applicable to non-tax state regulations affecting interstate commerce and that resulted in confusing and often conflicting results.[14] The *Complete Auto* test provides that a state tax violates the dormant commerce clause unless it:

(1) is applied to an activity with a substantial nexus to the taxing state;

(2) is fairly apportioned so as to tax only the activities connected to the taxing state;

(3) does not discriminate against out-of-state persons; and

(4) is fairly related to services provided by the state.[15]

III. THE *QUILL* "PHYSICAL PRESENCE" STANDARD FOR CERTAIN STATE TAXES

While the *Complete Auto* test is generally applicable to all state taxes, the Supreme Court has specifically addressed the "substantial nexus" prong for scrutiny of state transaction taxes, such as a sales or use tax. In *Quill Corp. v. North Dakota,* the Supreme Court held that a state tax law impermissibly burdens interstate commerce if it compels out-of-state entities to collect transaction taxes on its behalf, unless the out-of-state entity has a physical presence in the taxing jurisdiction.[16] In 1987, North Dakota changed its tax code to define "retailer" as a "person who engages in regular or systematic solicitation of a consumer market in th[e] state," and changed its regulations to define "regular or systematic solicitation" as consisting of three or more advertisements within a 12-month period. The state required all retailers to collect and

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[10] *See Gibbons v. Ogden,* 22 U.S. (9 Wheat.) 1 (1824) (invalidating state's grant of monopoly to steamship operator that prevented holders of Federal steamship licenses from navigating state waterways); ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES § 5.3 (2d ed. 2002).

[11] U.S. CONST. amend. XIV.

[12] *Complete Auto,* 430 U.S. at 279.

[13] *Complete Auto,* 430 U.S. at 287.

[14] *See generally* CHEMERINSKY, *supra* note 11, § 5.4.1.

[15] *Complete Auto,* 430 U.S. at 287.

[16] *Quill,* 504 U.S. at 317–18.

remit a use tax to the state. Quill Corporation, an office-supply company incorporated in Delaware whose only connection to North Dakota was that it sent catalogues to residents to solicit business, challenged the law on the basis that it violated the dormant commerce clause.

The Supreme Court held that Quill lacked sufficient nexus to North Dakota to enable the state to require collection and remittance of the use tax. In doing so, the Court reaffirmed the "physical presence" test for Commerce Clause nexus previously announced in *National Bellas Hess, Inc. v. Department of Revenue of Illinois.*[17] Accordingly, there is a bright-line rule that a state may impose a duty to collect and remit a use tax only on businesses that are physically present in the state.[18] However, with respect to *Quill's* separate argument that the Due Process Clause of the Fourteenth Amendment prohibited North Dakota from taxing it because it lacked certain minimum contacts with the state, the Supreme Court concluded that Quill "purposefully directed its activities at North Dakota residents, that the magnitude of those contacts are more than sufficient for due process purposes, and that the use tax is related to the benefits Quill receives from access to the State."[19]

Quill, if limited to its facts, applies the bright line physical presence nexus test only to a state's imposition of taxes that consumers are statutorily required to pay for the privilege of using or enjoying goods within a state's borders. It does not purport to establish a rule clarifying "substantial nexus" for a state's imposition of net income or other BATs on businesses that lack physical presence in the state.[20] From early dormant commerce clause cases it might appear that physical presence is the touchstone for at least *ad valorem* taxes, but the question of what constitutes physical presence for other taxes has been somewhat unclear.[21] In *Northwestern States Portland Cement Co. v. Minnesota,* the Supreme Court found physical presence based on the fact that an out-of-state company sent salesman into the taxing state to solicit business.[22] The Court thus allowed imposition of a net income tax on the otherwise out-of-state business. This ruling prompted Congress to enact Public Law 86–272 to clarify that merely sending traveling salesmen into a state does not result in physical presence for purposes of satisfying the nexus requirement of the dormant commerce clause.[23]

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[17] *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.,* 386 U.S. 753, 758–59 (1967) (declining to depart from bright-line rule requiring physical presence for taxing nexus).

[18] *Quill,* 504 U.S. at 317–18.

[19] *Id.* at 308.

[20] *See, e.g., KFC Corp. v. Iowa Dep't of Revenue,* 792 N.W.2d 308, 314 (Iowa 2010) ("While 'physical presence' may have been a significant feature, if not a requirement, in the Supreme Court's Dormant Commerce Clause analysis in early sales and use tax cases, 'physical presence' in the narrow sense does not appear as an important factor in cases involving state *income* taxation.") (Emphasis added.)

[21] *See Braniff Airways, Inc. v. Neb. State Bd. of Equalization & Assessment,* 347 U.S. 590, 597–98 (1954) (upholding state tax on airline that made 18 scheduled flights a day to and from Nebraska despite its having no other property there).

[22] *See Braniff Airways, Inc. v. Neb. State Bd. of Equalization & Assessment,* 347 U.S. 590, 597–98 (1954) (upholding state tax on airline that made 18 scheduled flights a day to and from Nebraska despite its having no other property there).

[23] *See* Pub. L. No. 86–272 (codified at 15 U.S.C. § 381 *et seq.* (2006 & Supp. IV)). BATSA amends Public Law 86–272 as described *infra.*

IV. "SUBSTANTIAL NEXUS" FOR NET INCOME AND OTHER BUSINESS ACTIVITY TAXES

While *Quill* defined the boundaries of a state's authority to impose sales and use taxes on out-of-state businesses, the precise boundaries of what constitutes a "substantial nexus" for purposes of net income and other BATs and, to the extent it might thereby be applicable, "physical presence" remain unclear. The West Virginia Supreme Court of Appeals recently held that "*Quill*'s physical presence requirement for a showing of substantial Commerce Clause nexus applies only to use and sales taxes and not to business franchise and corporate net income taxes."[24] The Iowa Supreme Court recently held that a Kentucky-based franchisor had "substantial nexus" to Iowa because it licensed intellectual property to a franchisee pursuant to a contractual relationship and the franchisee erected a sign bearing the licensed trademark on its property, but did not conclude whether physical presence was required for business activity tax nexus:

> As a result, we conclude that the Supreme Court would likely find intangibles owned by KFC, but utilized in a fast-food business by its franchisees that are firmly anchored within the state, would be regarded as having a sufficient connection to Iowa to amount to the functional equivalent of "physical presence" under *Quill.* Furthermore, the fact that the transactions that produced the revenue were based upon use of the intangibles in Iowa also provides a sufficient basis to support the tax under the Commerce Clause.[25]

Courts in other states, however, have opined that physical presence *is* required to satisfy the nexus requirement for all taxes. For example, in *J.C. Penney National Bank v. Johnson,* the Court of Appeals of Tennessee held that "[w]hile it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different [with respect to franchise and excise taxes]."[26]

Uncertainties in the law and the costs of compliance with the numerous and varied state and local tax regimes have increasingly become a significant burden on businesses. In addition to the high costs of the taxes themselves, businesses must also employ accountants to determine whether they are liable for various taxes and attorneys to defend themselves against enforcement actions. At a hearing in the 108th Congress, a representative of Smithfield Foods, Inc., testified:

> We incur substantial costs to meet our State tax obligations. On an annual basis we are required to file 860 State income tax returns, 450 sales and use tax returns, 3,150 State payroll tax returns and 215 real and personal property returns. This results in various State payment [sic] of almost $60 million. In spite of our efforts to comply with the laws of all the States, we continue to find State inter-

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[24] *Tax Comm'r of W. Va. v. MBNA America Bank, N.A.,* 630 S.E.2d 226, 232 (W. Va. 2006).
[25] *KFC,* 792 N.W.2d at 324.
[26] *J.C. Penney Nat'l Bank v. Johnson,* 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *appeal denied* (May 8, 2000), *cert. denied,* 531 U.S. 927 (2000).

> pretations of the business activity tax to be difficult and troublesome.[27]

The money spent on these administrative and compliance costs would be better put to making capital investments, growing the business, and hiring new employees, who will themselves bolster a state's tax rolls. Even if a business reasonably concludes it is not subject to taxation in a state, it may have to pay penalties if the state ultimately prevails in an enforcement suit. If the business concludes it is subject to taxation, it passes along the cost of the tax to consumers. In either case, goods and services become more expensive. These burdens are especially trying on small businesses which often lack the resources to hire specialized tax and legal experts. Worse still, some states have used very aggressive methods to collect their taxes. At the same hearing in the 108th Congress, Smithfield Foods testified that a truck delivering Smithfield hams was essentially hijacked on a New Jersey highway by the state's Department of Revenue in an effort to force the company to pay New Jersey's corporate income tax.[28]

Recent governance by the Financial Accounting Standards Board has only complicated the issue. As the Council on State Taxation, the National Association of Manufacturers, and the National Marine Manufacturers Association argued in their joint *amicus curiae* brief filed in 2007 in support of a petition for a writ of certiorari from the Supreme Court,

> The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice,* News Release (FASB), July 13, 2006 ("FIN 48"). FIN 48 provides uniform criteria for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is more likely than not that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.
>
> The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states will create havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality will be required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. Otherwise, the company will be required to accrue the full amount of any potential tax liability. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state

[27] *2004 Hearing, supra* note 2, at 36 (2004) (statement of Vernon T. Turner, Corporate Tax Director, Smithfield Foods, Inc.).
[28] *Id.* at 37.

> or locality. Taxpayers in identical circumstances could reasonably reach different conclusions. As a result, one taxpayer may accrue a 100% reserve of the potential tax liability while another identical taxpayer may reserve little or nothing at all.
>
> The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.[29]

V. DORMANT COMMERCE CLAUSE LIMITS ON APPORTIONMENT

If a state is permitted to collect a net income or other business activity tax from an out of state entity, it may not violate the dormant commerce clause with respect to how it apportions the entity's domestic business activities relative to the combined group's domestic and foreign business activities. The question of constitutional apportionment generally arises in states that require combined income or business activity reporting for an affiliated group of entities. To the extent that a state uses combined reporting, BATSA prohibits the state from taxing the income of an affiliate that has no physical presence in the taxing jurisdiction.

Hearings

On April 13, 2011, the Subcommittee on Courts, Commercial and Administrative Law held a legislative hearing on H.R. 1439 and heard testimony from: Rep. Bob Goodlatte; Rep. Robert C. "Bobby" Scott; Corey Schroeder, Vice President and CFO of Outdoor Living Brands, on behalf of the International Franchise Association; R. Bruce Johnson, Chairman of the Utah State Tax Commission, on behalf of the Federation of Tax Administrators; and Joseph Henchman, Tax Counsel and Director of State Projects at the Tax Foundation.

Numerous hearings on BATSA's predecessor bills and on the subject of tax nexus generally have been held in several prior Congresses.[30]

Committee Consideration

On July 7, 2011, the Committee met in open session and ordered the bill H.R. 1439 favorably reported without amendment, by voice vote, a quorum being present.

Committee Votes

In compliance with clause 3(b) of rule XIII of the Rules of the House of Representatives, the Committee advises that there was one recorded vote during the Committee's consideration of H.R. 1439. Rep. Chu offered an amendment to delay the effective date

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[29] Brief for Council on State Taxation et al. as Amici Curiae Supporting Petitioners at 18–19, FIA Card Services, N.A. v. West Virginia, 551 U.S. 1141 (2007) (denying petition for certiorari).

[30] *See supra* note 2.

of the bill to the year 2022. By a vote of 7–24, the amendment was not agreed to.

ROLLCALL NO. 1

	Ayes	Nays	Present
Mr. Smith, Chairman		X	
Mr. Sensenbrenner, Jr.		X	
Mr. Coble		X	
Mr. Gallegly		X	
Mr. Goodlatte		X	
Mr. Lungren		X	
Mr. Chabot		X	
Mr. Issa		X	
Mr. Pence		X	
Mr. Forbes			
Mr. King		X	
Mr. Franks		X	
Mr. Gohmert			
Mr. Jordan		X	
Mr. Poe			
Mr. Chaffetz		X	
Mr. Griffin		X	
Mr. Marino		X	
Mr. Gowdy			
Mr. Ross		X	
Ms. Adams		X	
Mr. Quayle		X	
Mr. Conyers, Jr., Ranking Member	X		
Mr. Berman			
Mr. Nadler	X		
Mr. Scott		X	
Mr. Watt		X	
Ms. Lofgren		X	
Ms. Jackson Lee		X	
Ms. Waters	X		
Mr. Cohen		X	
Mr. Johnson		X	
Mr. Pierluisi	X		
Mr. Quigley	X		
Ms. Chu	X		
Mr. Deutch			
Ms. Sánchez	X		
Ms. Wasserman Schultz			
Total	7	24	

Committee Oversight Findings

In compliance with clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee advises that the findings and recommendations of the Committee, based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

New Budget Authority and Tax Expenditures

Clause 3(c)(2) of rule XIII of the Rules of the House of Representatives is inapplicable because this legislation does not provide new budgetary authority or increased tax expenditures.

Congressional Budget Office Cost Estimate

In compliance with clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the Committee sets forth, with respect to the bill, H.R. 1439, the following estimate and comparison prepared by the Director of the Congressional Budget Office under section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 13, 2011.

Hon. LAMAR SMITH, CHAIRMAN,
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 1439, the Business Activity Tax Simplification Act of 2011.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Elizabeth Cove Delisle, who can be reached at 225–3220.

Sincerely,

DOUGLAS W. ELMENDORF,
DIRECTOR.

Enclosure

cc: Honorable John Conyers, Jr.
Ranking Member

H.R. 1439—Business Activity Tax Simplification Act of 2011.

SUMMARY

H.R. 1439 would prohibit State and local governments from taxing certain business activities that are taxable under current law. Specifically, it would prohibit those governments from taxing certain services, intangible goods, and media activities unless businesses providing those services have a "physical presence"—as defined in the bill—in the taxing jurisdiction.

ESTIMATED IMPACT ON THE FEDERAL BUDGET

CBO estimates that enacting H.R. 1439 would have no direct impact on the Federal budget. Because the bill would not affect direct spending or revenues, pay-as-you-go procedures do not apply.

ESTIMATED IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

H.R. 1439 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA) by prohibiting State and local governments from taxing certain business activities. CBO estimates that the costs—in the form of forgone revenues—to State and local governments would be about $2 billion in the first full year after enactment and at least that amount in subsequent years. The cost would far exceed the threshold established in UMRA for intergovernmental mandates ($71 million in 2011, adjusted annually for inflation).

Current law (notably, Public Law 86–272 and related Supreme Court decisions) prohibits States from levying a tax on the cor-

porate (net) income of a company whose only activity in the State is pursuing and making sales that would be filled from outside the State (e.g., mail order sales). H.R. 1439 would expand that prohibition to other types of business activity taxes (BATs), including additional corporate income taxes, franchise taxes, single business taxes, capital taxes, gross receipt taxes, and business and occupation taxes. Corporations currently pay these taxes to a State only if the State can establish "nexus" with the firm. ("Nexus" is the connection between a firm and a State that allows the State to legally impose taxes on the firm and is based on some measure of physical presence or economic activity in a State.) H.R. 1439 would redefine "nexus" and preempt State laws that are different from that definition. Such a preemption would constitute a mandate as defined in UMRA and would result in forgone revenues to State and local governments.

Specifically, the bill would:

- Define physical presence for firms not based in a State;
- Establish a uniform nexus standard nationwide—an entity would need to be physically present in a State for 15 or more days to establish nexus;
- Create "carve outs" from the 15-day standard that would allow certain industries or activities (such as media) to exceed the standard without establishing nexus with a State;
- Expand the prohibitions on taxation in Public Law 86–272 to include taxes not based solely on the income of a company (i.e., gross receipts taxes, franchise taxes, and business and occupation taxes);
- Expand the applicability of Public Law 86–272 to services and intangibles (e.g., the trademark for a retail store or the patent for a formula for soda); and
- Prohibit States that require businesses to file group returns from imposing BATs on members of the group that, by themselves, do not meet the standard for physical nexus.

ESTIMATED DIRECT COSTS OF MANDATES TO STATE AND LOCAL GOVERNMENTS

CBO estimates that enacting H.R. 1439 would result in revenue losses for States and some local governments and that such losses likely would total about $2 billion in the first full year after enactment and at least that amount in subsequent years. Those forgone revenues would equal about 3 percent of the total BATs in 2012 and would far exceed the threshold established in UMRA for intergovernmental mandates ($71 million in 2011, adjusted annually for inflation.)[1]

UMRA includes in its definition of mandate costs any amounts that State and local governments would be prohibited from raising in revenues as a result of the mandate. The mandate costs of H.R. 1439 would include any taxes that State and local governments

[1] In fiscal year 2010, States collected about $700 billion in total taxes. In the year following enactment, the revenue losses resulting from H.R. 1439 would total about 5 percent of collections from corporate income taxes and significantly less than 1 percent of total tax collections by States.

would be precluded from collecting under the bill. (UMRA's definition of mandate costs excludes increases in revenues that State and local governments might raise in reaction to enactment of a mandate.)

CBO estimates that all States and some local governments would see an immediate revenue loss because they are currently collecting taxes from firms that, under the bill, would be exempt from taxation. Subsequently, corporations likely 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. Those changes in business activities would likely result in additional revenue losses to the States. However, CBO has no basis for estimating the extent to which such reorganizations would occur.

BASIS OF ESTIMATE FOR INTERGOVERNMENTAL MANDATES COSTS

CBO used information from a variety of sources to estimate the State revenue losses that would result from enactment of this legislation.[2] Using data from the States, industry, and the Census Bureau, CBO estimated potential losses based on current tax collections, the industrial and commercial profile of State economies, and the structure of State taxing systems.

States use a variety of rules to determine whether a company is subject to taxation—that is, if it has nexus—and if so, how the activities in which that company engages are taxed. The differences in State taxing systems affect how much revenue each State or local government would likely forgo under the provisions of the bill. CBO examined both the characteristics of the corporate tax structure of each State and data about the economic makeup of each State in order to estimate potential revenue losses.

To estimate the costs of enacting H.R. 1439 to State and local governments, CBO first estimated the total amount of BATs paid by corporations in each State. Such taxes totaled about $65 billion in 2011. Since some industries are significantly less likely to be operating from outside the State than others (for example mining companies), CBO used information about the industrial and commercial makeup of States to calculate the portion of BATs that could be at risk if H.R. 1439 is enacted. In general, CBO expects that States would lose only a small percent of BATs—less than 3 percent in the first year after enactment, nationwide. To calculate losses for 2012, CBO estimated the likely percentage each State would lose based on its current tax system and applied that percentage to the BATs potentially at risk.

The percent of revenues lost by each State would vary significantly and would depend on the characteristics of each State's tax system and its industrial makeup. A State that imposes taxes on companies that make sales in the State—regardless of whether those companies have property or employees in the State—would lose a higher percentage of their BATs than would a State that only taxes companies that have a physical presence in the State. Similarly, a State that has an economy that is concentrated in an industry that does not rely on property or employees in the State

[2] Although the bill's provisions also would affect collection of taxes by some local governments, CBO has not separately estimated the potential losses for such governments. Relatively few local governments impose significant business activity taxes.

to carry out business activities, such as the information services industry, would also lose a higher percentage of their BATs than would a State where the economy relies more heavily on agricultural or manufacturing industries.

In the absence of this legislation, it is possible that some State and local governments would enact new taxes or change the way they tax businesses. Since such changes are difficult to predict, for the purposes of estimating the direct costs of the mandate, CBO considered only the revenues from taxes that are currently in place and actually being collected, or estimates for changes that are already in statute and that will be implemented over the next five years.

ESTIMATED IMPACT ON THE PRIVATE SECTOR

This bill contains no new private-sector mandates as defined in UMRA.

ESTIMATE PREPARED BY:

Impact on State, Local, and Tribal Governments: Elizabeth Cove Delisle
Federal Revenue: Kalyani Parthasarathy
Impact on the Private Sector: Paige Piper/Bach

Performance Goals and Objectives

The Committee states that pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, H.R. 1439 regulates certain state taxation of interstate commerce and modernizes Public Law 86–272.

Advisory on Earmarks

In accordance with clause 9 of rule XXI of the Rules of the House of Representatives, H.R. 1439 does not contain any congressional earmarks, limited tax benefits, or limited tariff benefits as defined in clause 9(e), 9(f), or 9(g) of Rule XXI.

Section-by-Section Analysis

Sec. 1. Short Title. Section 1 sets forth the short title of the Act as the "Business Activity Tax Simplification Act of 2011."

Sec. 2. Modernization of Public Law 86–272. Congress enacted Public Law 86–272 in 1959 in response to the United States Supreme Court's decision in *Northwestern States Portland Cement.*[31] In that decision, the Court concluded that a state has jurisdiction to tax the net income of a foreign corporation that maintained an active sales office and sales force within the State, even though the only activity that the corporation performed in the state was to solicit sales. Public Law 86–272 prohibits states from imposing a net income tax on businesses whose activities in their jurisdiction are limited to soliciting sales of tangible personal property, provided that the orders for the tangible personal property are approved and filled from a point outside the state.

Services and intangibles were not as vital to the American economy at the time Public Law 86–272 was enacted as they are now.

[31] 358 U.S. at 465.

Also, at that time, almost all states imposed a net income tax rather than some other type of business activity tax. As enacted, Public Law 86–272 does not apply to persons that solicit sales of services or intangibles, and it only applies to net income taxes, not to taxes such as gross receipts taxes, margin taxes, or commercial activity taxes that states have developed to substitute for net income taxes.

Section 2 modernizes Public Law 86–272 by extending its scope to persons that solicit sales of services and/or intangibles and by expanding its applicability from net income taxes to all BATs. Section 2 also adds language to shield from business activity tax liability persons who enter a state merely to furnish information to customers or affiliates in the state or to cover news or other events or gather information in the state, provided that such information is ultimately used outside the state.

Sec. 3. Minimum Jurisdictional Standard for State and Local Net Income and Other Business Activity Taxes. Section 3 clarifies a minimum jurisdictional standard for imposition of business activity tax. Under the Bill, a person must have "physical presence" in a state to be subject to business activity tax liability there. Under this section, a person has physical presence in a state if the person's activities in the state include at least one of the following during a taxable year: (1) the person is an individual physically in the state, or assigns one or more employees to the state; (2) the person uses the services of an agent to establish or maintain a market in the state, so long as the agent does not perform services in the state for any other person during the taxable year; or (3) the person leases or owns tangible personal property or real property in the state.

Section 3 also clarifies that a person is not considered to have a physical presence in the state if the person's activities there are limited to presence in the state (1) for fewer than 15 days in a taxable year; or (2) to conduct limited or transient business activity there.

The above protections would not apply to a person that is incorporated or formed under the laws of the state in which the tax is imposed.

Section 3 also clarifies that a state retains the right to use anti-tax avoidance tools, such as the economic substance and sham doctrines, to prosecute persons engaged in unlawful tax avoidance. It also clarifies that states retain the ability to require combined reporting for affiliates.

Sec. 4. Group Returns. Section 4 sets forth a rule for apportionment that prohibits a state from imputing the net income or other business activity of a non-present affiliate to an affiliate with nexus for purposes of enlarging the taxable portion of the affiliate group's income. In states that apportion, Section 4 limits the apportionment numerator to the indicia of economic activity physically present in the state, while preserving the denominator as the affiliate group's aggregated economic indicia, as the case may be in each respective state.

Sec. 5. Definitions and Effective Date. Section 5 sets forth definitions used in the Bill and makes the Bill effective as of January 1, 2012. Among other things, it requires that states treat each person in a group of affiliated persons separately for tax purposes.

Changes in Existing Law Made by the Bill, as Reported

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italics, existing law in which no change is proposed is shown in roman):

ACT OF SEPTEMBER 14, 1959

(Public Law 86–272)

AN ACT relating to the power of the States to impose net income taxes on income derived from interstate commerce, and authorizing studies by congressional committees of matters pertaining thereto.

TITLE I—IMPOSITION OF MINIMUM STANDARD

SEC. 101. (a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, 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

(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.

* * * * * * *

[(c) For purposes of subsection (a), 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, of tangible personal property.]

(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 any 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 fulfilling transactions, soliciting order for sales or 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.

(d) 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

* * * * * * *

SEC. 105. 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) of the Business Activity Tax Simplification Act of 2011. A State or political subdivision thereof may not assess or collect any tax which by reason of this section the State or political subdivision may not impose.

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Dissenting Views

INTRODUCTION

H.R. 1439, the "Business Activity Tax Simplification Act of 2011," would override state law to impose a problematic standard to determine if a state may tax a business activity.[1] This standard, based on whether a business is physically present in the state, and the bill's other provisions are onerous for several reasons. The legislation unfairly favors large, multi-state businesses over smaller businesses by creating massive state tax loopholes that large businesses will be able to exploit. Rather than clarifying the nexus requirement, the bill would engender more uncertainty and thereby result in more litigation. H.R. 1439, by preempting state law, would overturn well-settled state tax law practices and eviscerate state revenues. In essence, H.R. 1439 has a single objective: to relieve large multi-state and multi-national businesses from paying state taxes.[2] The Congressional Budget Office (CBO) estimates that H.R 1439 will cost states "*about $2 billion in the first full year after enactment and at least that amount in subsequent years.*"[3]

Citing these problems and other concerns presented by the bill, the National Governors Association, the Multistate Tax Commission, Citizens for Tax Justice, the Commonwealth of Massachusetts, the Governor of Oregon, the American Federation of State, County and Municipal Employees (AFSCME), the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO), the Communication Workers of America (CWA), the International Federation of Professional and Technical Engineers (IFPTE), the National Education Association (NEA), the American Federation of Teachers (AFT), the Department for Professional Employees (DPE), the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW), the International Association of Fire Fighters (IAFF), and the Services Employees Union International (SEIU) oppose H.R. 1439.[4]

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[1] A business activity tax is a direct tax on a business for doing business within the state, and is measured by the amount of such business or related activity. Generally, both in-state and out-of-state businesses that are "doing business" in a state pay business activity taxes on the money earned in that state.

[2] Letter from Oregon Governor John A. Kitzhaber, MD to the Oregon Congressional Delegation (Aug. 29, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff).

[3] Congressional Budget Office Cost Estimate, H.R. 1439: Business Activity Tax Simplification Act of 2011, 2 (Sept. 13, 2011) (emphasis added).

[4] Letter from Nebraska Governor Dave Heineman, Chair of the National Governors Association, and Delaware Governor Jack Markell, Vice Chair of the National Governors Association, to Representative Lamar Smith, Chairman of the House Committee on the Judiciary, and Representative John Conyers, Jr., Ranking Member of the House Committee on the Judiciary (Aug. 4, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff); Letter from Oregon Governor John A. Kitzhaber, MD to the Oregon Congressional Delegation (Aug. 29, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff); Letter from Massachusetts Secretary of Administration and Finance Jay Gonzalez to Senator Max Baucus, Senator Orrin Hatch, Representative Lamar Smith, Chairman of

Continued

For these reasons, and those discussed below, we respectfully dissent and urge our colleagues to reject this seriously flawed legislation.

DESCRIPTION AND BACKGROUND OF H.R. 1439

Under current jurisprudence, a state may impose a tax on a business if that business has a substantial nexus with the state, and the tax has some relation to the level of activity of the business within the state.[5] Whether a state may levy and collect a business activity tax on an out-of-state business depends upon what constitutes substantial nexus. Proponents of H.R. 1439 contend that substantial nexus demands a physical presence requirement.[6] For example, in *Geoffrey, Inc. v. South Carolina Tax Commission,*[7] the Supreme Court denied *certiorari* in a case where the South Carolina Supreme Court found sufficient connection between a Delaware corporation and the state of South Carolina to justify a business activity tax. The Delaware corporation's contact with the state consisted solely of the presence of intangible property.[8]

According to Professor Walter Hellerstein, one of the Nation's leading constitutional law experts, economic nexus is sufficient for purposes of determining whether a state may levy and collect a business activity tax on an out-of-state business.[9] The Supreme Court has held that when a state levies a tax against a multi-state business operating in its state, the state does not need to isolate intrastate income-producing activities from the entire business, but can tax an apportioned share of the total multi-state activities if

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the House Committee on the Judiciary, and Representative John Conyers, Jr., Ranking Member of the House Committee on the Judiciary (July 12, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff); Letter from Joe Huddleston, Executive Director of the Multistate Tax Commission to Representative Lamar Smith, Chairman of the House Committee on the Judiciary, and Representative John Conyers, Jr., Ranking Member of the House Committee on the Judiciary (July 5, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff); *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 245–247 (2011) (May 4, 2011 Letter from Robert S. McIntyre, Director of the Citizens for Tax Justice); *Id.* at 285–286 (May 4, 2011 Letter from the American Federation of State, County and Municipal Employees (AFSCME), American Federation of Labor and Congress of Industrial Organizations (AFL–CIO), Communication Workers of America (CWA), International Federation of Professional and Technical Engineers (IFPTE), National Education Association (NEA), American Federation of Teachers (AFT), Department for Professional Employees (DPE), International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW), International Association of Fire Fighters (IAFF), and the Services Employees Union International (SEIU)).

[5] Quill Corp.v. North Dakota, 504 U.S. 298 (1992).

[6] "Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that Bellas Hess established for sales and use taxes . . .", and, "In sum, although in our cases subsequent to Bellas Hess and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement. . . ." 504 U.S. at 314, 317.

[7] 313 S.C. 15, 437 S.E.2d 13, *cert. denied,* 510 U.S. 992 (1993).

[8] The Supreme Court has denied *certiorari* in other cases. *See, e.g.,* Lanco Inc. v. Director, Division of Taxation, 188 N.J. 380, 980 A. 2d 176 (2006), *cert. denied,* 127 S.Ct. 2974 (2007); 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); 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). For additional cases, *see The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 42–43 (2011) (Written Testimony of R. Bruce Johnson). By declining to consider these challenges, the Supreme Court has strengthened the argument that a state's ability to tax a business is not limited to a physical presence being established.

[9] *State Taxation: The Role of Congress in Defining Nexus: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 111th Cong. 67 (2010) (Written Testimony of Walter Hellerstein).

the business is unitary.[10] To survive a Commerce Clause challenge, the tax must pass the four-part test established in *Complete Auto Transit v. Brady.*[11] In order to be fairly apportioned, the tax must be proportional to the business activities occurring in that state.[12]

Nonetheless, H.R. 1439, introduced by Representative Bob Goodlatte on April 8, 2011, ignores Supreme Court precedent and the vast majority of state appellate courts by equating physical presence with substantial nexus and imposing such a standard. The legislation would preempt state law to provide that an out-of-state company must have a physical presence in a state before the state can impose a business activity tax. H.R. 1439 even goes further by amending Public Law 86–272 [13], which restricts the ability of states to impose net income taxes on interstate commerce.

H.R. 1439 contains five principal provisions which would shift more of the tax burden to local taxpayers and away from out-of-state businesses. Those provisions include:

- expanding the reach of Public Law 86–272 to apply to services and sales of intangible property of all interstate businesses.[14] Currently, Public Law 86–272 prohibits states from imposing a net income tax on businesses whose activities in their jurisdiction are limited to soliciting sales of tangible goods only, provided that the orders for the tangible goods are approved and filled from a point outside the state.
- expanding Public Law 86–272 to apply to all business activity taxes.[15] Currently, Public Law 86–272 applies only to state net income taxes.
- requiring a 15-day physical presence within a state before that state can impose, assess, or collect a net income tax or business activity tax on the entity.[16]
- allowing a business to have agents (which may be subsidiaries of the business) in a state acting on the business' behalf for an unlimited period of time without creating taxing jurisdiction as long as the agents are working for two or more principals.[17]
- preventing states from apportioning the income of a business which does not meet the physical presence standard as defined by the legislation.[18] In an effort to ensure that all income is taxed equitably, many states currently apportion the

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[10] A business is "unitary" if the intrastate and extrastate activities form "part of a single unitary business"and the out-of-state values that the state seeks to tax are not "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" MeadWestvaco Corp., Successor in Interest to The Mead Corp. v. Ill. Dep't of Revenue., 553 U.S. 16 (2008).

[11] 430 U.S. 274 (1977).

[12] To be proportionate, the tax must be both internally and externally consistent. The Supreme Court defines internal consistency as the following: "the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed." External consistency requires that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 169–170 (1983).

[13] Codified at 15 U.S.C. §§ 381–384.

[14] H.R. 1439, § 2(a).

[15] H.R. 1439, § 2(b).

[16] H.R. 1439, § 3.

[17] H.R. 1439, § 3(b)(1)(B).

[18] H.R. 1439, § 4.

income of a business for tax calculation purposes to the state in which the income was earned.

Taken together, these provisions will severely impact the collection of state income tax on business activity; create loopholes favoring large, multi-state corporations to avoid paying taxes; and undermine the ability of states to pay for essential services, such as public health and safety, education, and maintenance of state highways.

A more detailed section-by-section analysis of the legislation follows:

Sec. 1. Short Title. Section 1 sets for the short title of the bill as the "Business Activity Tax Simplification Act of 2011."

Sec. 2. Modernization of Public Law 86–272. Section 2 amends Public Law 86–272 by striking references to "tangible personal property". The deletion effectively extends the reach of Public Law 86–272, which prohibits states from imposing business net income taxes where the company's only activity within the state is solicitation in connection with sales and transactions of tangible personal property. Thus, businesses whose sole activity within a state is the sales of tangible and intangible personal property and services would be safe from state business net income taxes.

Sec. 3. Minimum Jurisdictional Standard for State and Local Net Income Taxes and Other Business Activity Taxes. Subsection (a) of section 3 prohibits a state from imposing a business activity tax on any person unless such person has a physical presence in the state.

Subsection (b)(1) provides that "physical presence" is established only if the business activities within the state include any of the following: (A) the person has employees in a state; (B) the person uses a third party to provide services that enhance or maintain the person's market in a state, unless the third party performs market-enhancing services for at least one other business; or (C) the person leases or owns tangible personal property or real property in a state.

Subsection (b)(2) provides that "physical presence" does not include *de minimis* physical presence, defined to include a presence in a state for up to 14 days in a taxable year (or a greater number of days if provided by state law) or presence in a state to conduct limited or transient business activity.

Subsection (c) provides that the 14-day limitation will be prorated if a taxable period is not based on a taxable year.

Subsection (d) provides that the physical presence standard is a minimum standard for state tax jurisdiction and would not supersede any law that allows a person to conduct greater activities without the imposition of tax jurisdiction.

Subsection (e) describes the three situations where the prohibition of section 3(a) does not apply or does not affect current law. These situations include when a business is incorporated or formed under the laws of the state, when an individual is a resident of the state, or when a business is engaged in an illegal activity.

Sec. 4. Group Returns. Section 4 limits a state's apportionment calculation to determine a net income or other business activity tax liability. Where net income of affiliated persons are considered, the amount of combined net income subject to tax shall be computed

using generally applicable methodologies, but if the methodology employs an apportionment formula, then the denominator shall include aggregate factors of all persons included in such combined net income and the numerator shall include factors attributable to the state of only those persons with physical presence in the state. In other words, section 4 would ensure that a state would not be allowed to include income from affiliates of a business which do not have physical presence in the state when calculating the income of that business for tax purposes.

Sec. 5. Definitions and Effective Date. Section 5 defines certain terms used in the Act.

This section also provides that the legislation becomes effective for taxable years beginning on or after January 1, 2012.

CONCERNS WITH H.R. 1439

I. H.R. 1439 WILL DEVASTATE STATE REVENUES

H.R. 1439 will severely impact state revenues in the short term and progressively in the long term. The CBO estimates that H.R 1439 will cost states "*about $2 billion in the first full year after enactment and at least that amount in subsequent years.*"[19] This impact would far exceed the Unfunded Mandates Reform Act threshold of $71 million in 2011.[20] For perspective, $2 billion would pay the salaries for more than 36,000 public school teachers.[21] And, this amount in lost state revenues would likely increase substantially over the years. As the CBO explained, 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. Those changes in business activities would likely result in additional revenue losses to the states."[22] Separately, Oregon has predicted that H.R. 1439 would lead to between $90 and $116 million in lost revenue per year, which is about 19% of the state's corporate income tax revenue.[23]

In 2006, the CBO estimated that legislation similar to H.R. 1439 would have led to "virtually all states [losing] revenues, [and] about 70 percent of the estimated losses would come from ten states: California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington."[24] One would expect a similar present impact.

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[19] Congressional Budget Office Cost Estimate, H.R. 1439: Business Activity Tax Simplification Act of 2011, 2 (Sept. 13, 2011) (emphasis added).

[20] The Unfunded Mandates Reform Act is intended to curb the practice of imposing Federal mandates on state and local governments without adequate funding. Unfunded Mandates Reform Act of 1995, Pub. L. No. 104–4, 109 Stat. 48 (1995).

[21] $2 billion is more than sufficient to finance the annual salaries of 36,230 teachers paid at the national average salary of $55,202, as calculated by the National Education Association. National Education Association, Rankings of the States 2010 and Estimates of School Statistics 2011, at 17, 19, *available at* http://www.nea.org/assets/docs/HE/NEA_Rankings_and_Estimates010711.pdf.

[22] Congressional Budget Office Cost Estimate, at 3.

[23] Letter from Oregon Governor John A. Kitzhaber, MD to the Oregon Congressional Delegation (Aug. 29, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff).

[24] H.R. Rep. No. 109–575, at 11 (2006).

II. H.R. 1439 WILL EFFECTIVELY ELIMINATE THE TAX BURDEN FOR OUT-OF-STATE COMPANIES

H.R. 1439 is "another example of large, multi-state corporations trying to shirk their tax responsibilities."[25] Simply, it will substantially diminish the ability of states to tax business activity within their borders, thus favoring multi-state corporations at the expense of local businesses and taxpayers. The bill does so in several respects.

A. The Bill's Expanding Public Law 86–272 Will Favor Out-of-State Businesses

H.R. 1439 expands the prohibition in Public Law 86–272 to apply to services and sales of intangible property of all interstate businesses, rather than just the current sales of tangible property.[26] Public Law 86–272 already "allows corporations to have an *unlimited* number of salespeople in a state at *all times* yet remain exempt from income tax if the salespeople work out of home offices or visit from out of state."[27] By expanding the reach of Public Law 86–272, H.R. 1439 would exempt from income tax business sectors which focus on selling intangible goods and services. As a result, tax revenues for states would be further reduced.

B. The Bill's Physical Presence Test Will Encourage Tax Evasion

H.R. 1439 requires a business entity to have a 15-day physical presence within a state before that state can impose, assess, or collect a net income tax or business activity tax on such entity.[28] The bill's physical presence standard, however, includes several safe harbors for businesses, thereby making the tax system more arbitrary, inconsistent, and complex. The standard favors businesses with limited physical presence but that may actually have major economic activity within the state, while shifting the state corporate income tax burden to local, small businesses and manufacturers, and natural resource and service industries, that is, businesses that pay local property and payroll taxes.

Nebraska Governor Dave Heineman and Delaware Governor Jack Markell have stated that H.R. 1439 would create "opportunities for companies to structure corporate affiliates and transactions to avoid paying state taxes."[29] The bill would shield business income from taxation regardless of how much income businesses derive from the state seeking to impose a tax on them. For example, H.R. 1439's 15-day physical presence test[30] effectively creates a 14-

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[25] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 247 (2011) (May 4, 2011 Letter from Robert S. McIntyre, Director of the Citizens for Tax Justice).

[26] H.R. 1439, § 2.

[27] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 234 (2011) (Prepared Statement of Michael Mazerov).

[28] H.R. 1439, § 3.

[29] Letter from Nebraska Governor Dave Heineman, Chair of the National Governors Association, and Delaware Governor Jack Markell, Vice Chair of the National Governors Association, to Representative Lamar Smith, Chairman of the House Committee on the Judiciary, and Representative John Conyers, Jr., Ranking Member of the House Committee on the Judiciary (Aug. 4, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff).

[30] H.R. 1439, § 3(b)(2)(A).

day safe harbor. According to noted state and local taxation expert Michael Mazerov,

> In short, BATSA's 14-day safe harbor would allow many sophisticated multi-state corporations to avoid having a business activity tax liability in many or all states in which they have customers. Firms could maintain substantial numbers of employees and substantial amounts of equipment in a state on a continuously rotating basis without creating BAT nexus.[31]

Meanwhile, in-state based companies would easily exceed the 14-day safe harbor and be subject to business activity taxes. Thus, the legislation's physical presence standard would favor businesses with limited physical presence but often with major economic activity within the state, while shifting the state corporate income tax burden to local businesses.

By encouraging tax evasion through the creation of tax shelter opportunities for nonresident businesses—which would be primarily businesses with ample resources—the bill makes the tax system more arbitrary, inconsistent, and complex.[32] As the nonpartisan Congressional Research Service explained, "[T]he 15-day rule and the safe harbor for limited or transient activity . . . would increase opportunities for tax planning and thus tax avoidance and possibly evasion."[33] As a result, a business could avoid paying taxes in a state that apportions income based solely on sales (single sales factor apportionment formula) by locating its physical assets in that state, while directing its sales in that state through an out-of-state company.[34] For these reasons, at the markup, Representative Judy Chu offered an amendment to strike the provision providing for these carve-outs, but the amendment was defeated by voice vote.[35]

H.R. 1439 will allow out-of-state businesses to reap the benefits of state-provided services without having to pay for them. Supporters of this legislation argue that out-of-state businesses should not have to pay business activity taxes because they assert they do not benefit from state provided services.[36] "Although this point of view may have some political cache, it is factually unsupportable."[37] Such businesses often benefit substantially from state pub-

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[31] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 238 (2011) (Prepared Statement of Michael Mazerov).

[32] *The Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 110th Cong. 52 (2008) (Written Testimony of David Quam).

[33] Congressional Research Service Report for Congress, State Corporate Income Taxes: A Description and Analysis, RL32297 (June 23, 2008).

[34] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 45 (2011) (Written Testimony of R. Bruce Johnson).

[35] *The Business Activity Tax Simplification Act of 2011: Markup of H.R. 1439 Before the H. Comm. on the Judiciary,* 112th Cong. (July 7, 2011) (Amendment #3 of Representative Judy Chu).

[36] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 34 (2011) (Written Testimony of Corey Schroeder); *see also* John A. Swain, State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective, 45 WM. & MARY L. REV. 319, 378 (Oct. 2003).

[37] Swain, *supra* note 36, at 379.

lic services such as fire and police protection.[38] Out-of-state companies compete with in-state mom-and-pop stores for customers and, like every other company doing business within the state, benefit from the transportation services the state provides.[39] Also, when an out-of-state bank makes mortgage loans in a state, the value of the houses that serve as collateral depends on the quality of local schools and the safety of the community. Furthermore, that same out-of-state bank would use the local court system if legal action is necessary for non-payment of mortgage loans. Each of these services is provided by the state notwithstanding a company's lack of physical presence in that state.

C. The Bill Severely Restricts the Ability of States To Apportion Tax Liability

H.R. 1439 would severely restrict the ability of states to apportion the income of a business that does not meet the physical presence standard as defined by the legislation.[40] Currently, some states include in their tax calculations the income of all entities of a business enterprise if one of those entities has a physical presence within the state.[41] Combining the income ensures that a parent company does not avoid paying state business activity taxes by merely creating holding companies or affiliates to avoid establishing a physical presence. H.R. 1439, however, would favor businesses that have not established physical presence, as defined by the bill, by excluding from net income tax calculations holding companies and other entities.[42] Thus, large multistate businesses will have less tax liability.

III. H.R. 1439 WILL FORCE STATES TO CUT ESSENTIAL SERVICES AND INCREASE TAXES ON LOCAL TAXPAYERS

As a policy matter, we note that state and local governments work closely with the Federal Government to provide essential government services such as educating our children, maintaining needed transportation infrastructure, and protecting us from domestic and foreign terrorism. State and local governments pay for these services through tax revenues. States, however, would be severely hampered in their ability to provide these essential services if Congress restricts their ability to collect much needed revenues as proposed by H.R. 1439, which, in turn, would adversely impact revenues local governments receive from their state counterparts.

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[38] Charles McClure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," State Tax Notes, 721–735, 734–735, March 1, 2004.

[39] *The Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 110th Cong. 50 (2008) (Testimony of David Quam); *see also The Business Activity Tax Simplification Act of 2003: Hearing on H.R. 3220 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 108th Cong. 125 (2004) (Prepared Statement of the Multistate Tax Commission).

[40] H.R. 1439, § 4.

[41] For a thorough discussion on apportionment, *see State Taxation: The Role of Congress in Developing Apportionment Standards: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 111th Cong. (2010), and particularly the written testimony of Daniel B. De Jong, at 37–39, for a dissection of the Joyce and Finnigan approaches, which this provision in the legislation addresses.

[42] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 64 (2011) (Testimony of R. Bruce Johnson).

H.R. 1439 will eviscerate state revenues by excluding from possible state taxation billions of dollars in current business income. Thus, to balance their budgets, states will be forced to cut services and shift most of the tax burden onto local taxpayers through increased property, income, and sales taxes.

H.R. 1439 will restrain the states' ability to cope with economic downturns in several respects. First, the legislation will deny states the flexibility to raise revenue.[43] Second, H.R. 1439's inflexible effective date (January 1, 2012) fails to take into consideration that it is midway through most states' fiscal years, and may not give states sufficient time to adjust their budgetary commitments to take into consideration the expected revenue losses.[44] At the markup, Representative Judy Chu offered an amendment to change the effective date to January 1, 2022, which would provide sufficient time for state governments to plan accordingly.[45] This amendment, however, was defeated.[46] Third, H.R. 1439 will hinder the states' ability to balance their budgets. Most states are required, either statutorily or constitutionally, to balance their state budgets.[47] Budgets are based on anticipated revenue and spending for the fiscal cycle. When revenue declines or spending increases during the fiscal cycle, states begin to run a deficit. States must then account for the deficit by cutting spending or raising taxes.

During the current economic climate, the state tax revenue base has declined as a result of higher unemployment, lower real estate property taxes, and less sales tax revenue. The need for state and local government services, however, has not correspondingly declined. In fact, demand for many of these essential services, such as unemployment payments and other social programs, has increased during the current economic downturn.[48]

The Center on Budget and Policy Priorities estimates that the states will face combined budget shortfalls of $103 billion for fiscal year 2012.[49] To balance their budgets, state and local governments already have had to respond through measures which heavily impact working families. For example, 44 states have cut more than 400,000 public sector jobs since August 2008; California, Michigan, and Delaware have slashed benefits to families living below the poverty line; and Texas cut about $1 billion in education funding over the past 2 years from its already well below-average education budget and another $1 billion from its higher education budget.[50] Additionally, some states have reduced their aid to local govern-

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[43] *State Taxation: The Impact of Congressional Legislation on State and Local Government Revenues: Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary,* 111th Cong. 27–28 (2010) (Testimony of Vermont Governor Jim Douglas).

[44] H.R. 1439, § 5(b).

[45] *The Business Activity Tax Simplification Act of 2011: Markup of H.R. 1439 Before the H. Comm. on the Judiciary,* 112th Cong. (July 7, 2011) (Amendment #2 of Representative Judy Chu).

[46] The amendment failed by a roll call vote of 7–24. *Id.*

[47] National Association of State Budget Officers, Budget Processes in the States 40 (Summer 2008).

[48] Donald J. Boyd, Nelson A. Rockefeller Institute of Government, Recession, Recovery, and State-Local Finances, Presentation before the Forecasters Club of New York 2, Jan. 28, 2010.

[49] Center on Budget and Policy Priorities, New Fiscal Year Brings Further Budget Cut to Most States, Slowing Economic Recovery, June 28, 2011.

[50] *Instead of Signs of Recovery, a Sucker Punch for State Budgets,* WASH. POST, May 29, 2011, at G7.

ments for fiscal 2012.[51] The lost aid may lead to fewer police officers on the street, which could result in more crime, or less funding for hiring teachers, which could further depress our educational system. "By depriving states of business activity tax revenues they currently are collecting, the legislation could further impair their ability to provide services that are a critical foundation of a healthy national economy—such as high-quality K–12 and university education and transportation infrastructure."[52] Labor organizations fear that the "annual loss [in revenue] would worsen state and local budget problems and force cuts to education, health care, job creation and other vital services."[53] Enactment of H.R. 1439 would force states to cut essential services.

Instead of spending less on essential services, states could choose to increase taxes to cover the revenue losses expected after enactment of H.R. 1439. According to Utah State Tax Commissioner R. Bruce Johnson, the expected revenue loss by H.R. 1439 "is not revenue that is going to go away, . . . That tax is going to be shifted to our local businesses and our local taxpayers. It is going to have a devastating impact on small business."[54] In sum, H.R. 1439 will burden local taxpayers while excusing out-of-state businesses from paying their fair share of taxes.

IV. H.R. 1439 WILL INCREASE LITIGATION COSTS FOR SMALL BUSINESSES AND STATE GOVERNMENTS

H.R. 1439 will not minimize litigation, as its supporters contend.[55] Instead of providing a clear physical presence standard that will decrease litigation, H.R. 1439 "contains numerous undefined terms that will generate considerable litigation".[56]

Two simple examples highlight the many uncertainties that H.R. 1439 creates. First, H.R. 1439 describes "physical presence" as "[u]sing the services of an agent (excluding an employee) to establish or maintain the market in the State, if such agent does not perform business services in the State for any other person during such taxable year."[57] The legislation leaves to the courts to interpret the vague terms "establish or maintain," "perform business," and "services." Second, H.R. 1439 allows a business to "conduct limited or transient business activity" within a state without establishing a physical presence.[58] According to an analysis of the Business Activity Tax Simplification Act by the Federation of Tax Administrators, a court will likely have to interpret the terms "limited" and "transient" because they are undefined in the legislation:

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[51] National Governors Association and National Association of State Budget Officers, The Fiscal Survey of States, Spring 2011, at 8, *available at* http://www.nasbo.org/LinkClick.aspx?fileticket=yNV8Jv3X7Is%3d&tabid=38.

[52] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 226 (2011) (Prepared Statement of Michael Mazerov).

[53] *Id.* at 285–286.

[54] *The Business Activity Tax Simplification Act of 2011: Hearing on H.R. 1439 Before the Subcomm. on Courts, Commercial and Admin. Law of the H. Comm. on the Judiciary,* 112th Cong. 37 (2011) (Statement of R. Bruce Johnson).

[55] *Id.* at 3 (Statement of Representative Bob Goodlatte).

[56] *Id.* at 212.

[57] H.R. 1439, § 3(b)(1)(B).

[58] H.R. 1439, § 3(b)(2)(B).

> [A] company's activity could be permanent but limited in scope, or unlimited in scope but not permanent, and still be protected from taxation. . . . For example, a corporation whose charter or application to conduct business in the state indicates that it will engage only in banking activities and nothing else (so that its activities are "limited," as "restricted in . . . scope") could be protected from taxation even if in the state permanently, as could a corporation whose charter or application indicates that it will engage in every activity in the state that a corporation may legally perform, but will do so only for 10 years (so that its activities are "transient," as "not permanent").[59]

Given these and other substantial new limitations on their ability to raise revenue, states undoubtedly will litigate to establish the narrowest interpretations of the terms within H.R. 1439.[60] This increased litigation will lead to more legal costs for states and multi-state businesses, contrary to proponents of the bill.

CONCLUSION

H.R. 1439 is irresponsible legislation that will have a devastating impact on state revenues, force state governments to eliminate essential governmental programs and services, burden local taxpayers, and favor large multi-state businesses over local businesses. For all of these reasons, we respectfully dissent.

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[59] Matt Tomalis, *Some Fatal Flaws of S. 1726, H.R. 5267 and All BAT Nexus Bills,* State Tax Notes, Mar. 3, 2008, at 691–703, 695.

[60] For example, according to Oregon Governor Kitzhaber, "enactment of H.R. 1439 would result in substantial litigation and uncertainty as the new boundaries it would create are refined in the courts." Letter from Oregon Governor John A. Kitzhaber, MD to the Oregon Congressional Delegation (Aug. 29, 2011) (on file with the House of Representatives Committee on the Judiciary, Democratic Staff).