Coalition for Interstate Tax Fairness & Job Growth

www.interstatetaxfairness.com

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Re: Public Comments: House Ways & Means Committee – Tax Reform Working Groups

Members of the Committee,

The Coalition for Interstate Tax Fairness & Job Growth ("Job Growth Coalition") submits these comments regarding the lack of a national standard as to when states and localities may impose business activity taxes on out-of-state businesses. The Job Growth Coalition is a diverse coalition of American businesses involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and entertainment and service businesses.

The Job Growth Coalition believes that a bright-line, quantitative physical presence nexus standard is the appropriate standard for state and local taxation of out-of-state businesses and that the modernization of Public Law 86-272 is essential for the health and growth of the American economy. The physical presence standard and modernization of Public Law 86-272 are included in the Business Activity Tax Simplification Act ("BATSA"), which has been introduced in Congress in the past and, we understand, will likely be introduced later this year.[1] The Job Growth Coalition strongly supports BATSA and respectfully urges the Committee to include a physical presence nexus standard for state and local taxation and modernization of PL 86-272 as part of ongoing tax reform efforts.

I. BACKGROUND

Some state revenue departments and state legislatures have been creating barriers to interstate commerce, based on the recently-minted notion of economic nexus, by aggressively attempting to impose direct taxes on out-of-state businesses that have little or no connection with their state. Specifically, some states have asserted that they can tax a business with no property or employees in the state, based merely on the business having customers in the state. The economic nexus concept flies in the face of the traditional nexus standards applied to business activity taxation, which is largely based on the eminently valid notion that a business should be subject to tax only by those states from which the business receives meaningful benefits and protections.

Confronted with aggressive, and often constitutionally questionable,[2] efforts of states to tax their income when they have little or no presence in the jurisdiction, American businesses are

[1] Note that BATSA was most recently introduced as the Business Activity Tax Simplification Act of 2011, H.R. 1439.

[2] *See, e.g., Capital One Bank v. Mass. Comm'r of Rev.*, 899 N.E.2d 76 (Mass. 2009), *cert denied* 2009 U.S. LEXIS 4616 (2009); *West Virginia Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E. 2d 226 (W. Va. 2006), *cert.*

(continued…)

faced with a difficult choice. They can challenge the specific tax imposition – but must bear substantial litigation costs to do so. Or, they can knuckle under to the states and pay the asserted tax – but then they risk being subject to multiple taxation and, in the case of publicly traded companies, they risk violating their fiduciary responsibilities to their shareholders (by paying invalid taxes) and hence, become subject to shareholder lawsuits. Unfortunately, the latter choice is sometimes made, especially since some states are utilizing "hardball" tactics.[3] Moreover, companies making the latter choice are faced with immense compliance burdens in complying with state business activity taxes. By some estimates, there are over 3,000 taxing jurisdictions in the United States.[4]

Federal legislation to clarify the requirement of a physical presence nexus standard for business activity taxes would ensure that the economic burden of state tax impositions is – appropriately – borne only by those businesses that receive benefits and protection from the taxing state and ensures that businesses pay these taxes only to those states and localities where they have earned income (*i.e.*, where they have their employees and their property). Perhaps most important, the physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners.

II. JOB GROWTH

The provisions in BATSA would help domestic job growth in a variety of ways. First, as discussed in detail below, foreign companies will be more likely to invest in the United States and create jobs if they can be certain of the tax burdens that would arise from that investment. Second, BATSA would make it more likely for U.S. companies to invest in the U.S. Under PL 86-272, federal law has long prohibited states from imposing a tax on a company if that company's presence in the state is solely due to the solicitation of sales of tangible personal property. As the U.S. economy becomes more and more of a service economy, with respect to companies who have presence in a state solely related to the solicitation of sales, the current structure of PL 86-272 has the negative effect of allowing states to impose tax on service-based companies while exempting companies primarily engaged in selling tangible personal property. This disparate treatment has a chilling effect on service-based companies and discourages them from growing their businesses and creating jobs. Finally, BATSA will put the U.S. on a level playing field with other countries in terms of the certainty of tax burdens. In the current climate, U.S. companies are encouraged to invest in other countries instead of the U.S. because the tax liability in other countries is more certain than the liability in the U.S.

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denied, 2007 U.S. LEXIS 7868 (2007); and *J.C. Penney National Bank v. Johnson,* 19 S.W.3d 831 (Tenn. Ct. App. 1999), *app. denied* (Tenn. 2000), *cert. denied*, 531 U.S. 927 (2000).

[3] *See, e.g., Business Activity Tax Simplification Act of 2008: Hearing on H.R. 5267 Before the House Comm. on Small Business*, 110th Cong. (2008) (testimony of Barry Godwin, on behalf of National Marine Manufacturers Association).

[4] Ernst & Young, *State and Local Jurisdictions Imposing Income, Franchise, and Gross Receipts Taxes on Business* (March 7, 2007).

III. PROTECTION OF SMALL BUSINESS

Economic nexus theories have a disproportionately adverse impact on smaller companies. While the tremendous problems associated with multiple versions of an economic presence standard make compliance with varying business activity tax laws burdensome for larger companies, the impact on small and medium-sized businesses is especially onerous.

The Direct Marketing Association has estimated that there are more than 479,500 businesses in the U.S. with annual revenue of ten million dollars or less that engage in remote marketing in one or more states in which they have no physical presence. This group of small businesses collectively had estimated combined annual revenue of $299.4 billion dollars in 2006, and employed an estimated total of 1.13 million people.

Smaller businesses are hardest hit by widespread use of the economic nexus standard. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are triggered by the economic nexus standard. Moreover, the prospect of challenging an incorrect assessment in a remote jurisdiction is daunting and expensive, thus many smaller businesses faced with improper tax assessments are left with no choice but to pay the tax and forget their objections.

IV. EFFECT ON INTERNATIONAL TAXATION AND AMERICAN COMPETITIVENESS

Our country's own history and the federal government's position in the context of international taxation provide a strong reason to establish a physical presence nexus standard. Specifically, a physical presence nexus standard would promote consistency between international tax and state tax jurisdictional standards. For over 80 years, the United States, along with most other countries in the world, has adopted and implemented the "permanent establishment" standard in its income tax treaties with foreign jurisdictions. This standard is derived from the Model Tax Convention of the Organisation for Economic Co-operation and Development ("OECD").[5] Unlike many U.S. states and localities, the OECD Model Tax Convention employs a physical presence jurisdictional standard.[6] A country should not be able to impose a tax on a company unless there are activities, authorized by the company, carried out on the company's behalf within the country that seeks to impose a tax.[7] A state adhering to economic nexus clearly does not consider itself bound to this standard. If a more expansive jurisdictional standard is widely adopted for state tax purposes than that used by the federal government for international tax purposes, it would surely dampen foreign investment in the United States. Even if tax reform at the federal level lessens the tax burdens on foreign

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[5] Jerome B. Libin & Timothy H. Gillis, *It's a Small World After All: The Intersection of Tax Jurisdiction at International, National, and Subnational Levels*, 38 Ga. L. Rev. 197, 204 (2003).

[6] *See* Libin & Gillis, *supra* note 39, at 204.

[7] *See Tennessee v. NV Sumatra Tobacco Trading Co.*, Tenn. S.Ct. No. M2010-01955-SC-R11-CV (Mar. 28, 2013) (citing *International Shoe v. Washington*, 326 U.S. 310, 316-17 (1945) (discussing the limitations that the due process clause places on a state's personal jurisdiction).

companies looking to invest in the United States, those companies may still be hesitant to invest if they are uncertain of the state and local tax burdens that may be imposed on that investment.

V. FEDERALISM

Contrary to the arguments of some opponents of clarifying the standards for state business activity taxes,[8] considerations of federalism support passing the objectives sought by BATSA. First, state sovereignty would be protected by preventing one state from imposing tax on activities that actually take place in another state; economic nexus is the predicate some states are using to do just that. A state should not be able to reach out beyond its own limits to tax activities that occur exclusively within the bounds of a coequal sovereign.[9] Second, a fundamental aspect of American federalism is that Congress has the authority and responsibility to ensure that interstate commerce is not burdened by state actions (including taxation of such commerce).[10] In fact, the Supreme Court has explicitly noted Congress' role in the area of multistate taxation.[11] Even if tax reform at the federal level successfully reduces tax burdens on American businesses, those businesses will continue to be subject to inappropriate state and local tax burdens unless Congress acts.

VI. CONCLUSION

The principles embedded in BATSA would substantially reduce the burdens on interstate commerce that are being created by the adoption of economic nexus by many states. The Supreme Court has explicitly stated that Congress is better equipped to resolve these issues than the Court.[12] In many cases, state and local taxes can be as much if not more of a burden on companies than federal taxes. Therefore the provisions contained in BATSA should be considered as part of any tax reform.

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[8] *See*, *e.g.*, *Federalism at Risk: A Report by the Multistate Tax Commission*, Multistate Tax Commission (June 2003); *Respecting Federalism*, Multistate Tax Commission Policy Statement 03-01.

[9] *See Tennessee v. NV Sumatra Tobacco Trading Co.*, Tenn. S.Ct. No. M2010-01955-SC-R11-CV (Mar. 28, 2013) (citing *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 291-92 (1980) (discussing the limitations that the due process clause places on a state's personal jurisdiction).

[10] *See, e.g.*, Diann L. Smith, *Supreme Court Would Uphold P.L. 86-272* (letter to the editors), 25 State Tax Notes 135 (July 8, 2002) (discussing the authority of Congress to regulate interstate commerce).

[11] *Barclay's Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

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