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January 25, 2008

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Re: Nexus Requirements For Imposition Of Business Activity Taxes

I am writing on behalf of the Tax Section (the "Tax Section") of the New York State Bar Association to recommend that Congress exercise its Commerce Clause authority to establish clear jurisdictional standards for a state's imposition of tax on the income or receipts of a business (herein a "business activity tax").[1] The current lack of such clear

[1] This letter was prepared by the Committee on Multistate Tax Issues of the Tax Section, Robert E. Brown and Paul R. Comeau, co-chairs. Robert E. Brown and Paul S. Fusco were the principal drafters of this letter. Helpful comments were received from Patrick C. Gallagher, David R. Hardy, Stephen B. Land, Carolyn Joy Lee, Robert J. Levinsohn, David S. Miller, Erika W. Nijenhuis and Michael L. Schler. The comments in this letter are made solely on behalf of the Tax Section and not on behalf of the New York State Bar Association as a whole (which would require approval by its House of Delegates).

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standards is very burdensome to businesses. It creates considerable inefficiencies as taxpayers endeavor to understand differing state positions and standards. It is also a problem because inconsistent positions among the states regarding nexus lead to differences in the application of other substantive tax rules, such as throw-back rules, and royalty add-back provisions.

Some have argued that a business must have a "physical presence," meaning employees and tangible property, in a state before the state can impose a business activity tax on that business. Others have argued that the mere presence of customers, so-called "economic presence," is sufficient to support imposition of a business activity tax.

We recommend that Congress adopt a clear minimum nexus standard for a state's imposition of business activity tax. As set forth below, we believe that "economic presence" is a necessary component in properly matching the incidence of taxation with the economic realities of the taxpayer doing business among the states. As we also discuss below, we understand that the realities of enforcement and administration as well as the need to provide certainty for taxpayers may require a hybrid scheme that includes some elements of physical presence and a *de minimis* economic presence threshold that would preclude the imposition of tax if economic activity in the state is minimal.

Accordingly, we recommend that the nexus standard adopted by Congress (1) take into account "economic presence" rather than being limited to a pure "physical presence" test, and (2) also include a reasonable *de minimis* threshold so that the administrative burdens of tax compliance in a state fall only on those taxpayers whose activities linked to the state justify the burden. In addition, we recommend that, as part of its consideration of a business activities nexus standard, Congress explore whether to adopt a uniform rule for apportioning income between states, and whether the nexus rule for business activities taxes should be the same as the nexus rule for use taxes, although we make no recommendation in this letter as to how Congress should resolve these issues. We will be happy to provide supplemental letters on those topics if requested to do so.

We believe that the proper balance between the desire of states to protect their revenues and the need for fairness, certainty and consistency in the imposition of tax-related obligations on out-of-state businesses can best be struck by Congress with thoughtful legislation under its Commerce Clause authority. In fact, in a report we issued some 21 years ago on the proposed Interstate Sales and Use Taxation Act of 1986 we noted that the sales and use tax nexus problem "can best be addressed by federal legislation pursuant to the Commerce Clause."[2] We also commented in that report that "we believe it may be particularly appropriate to consider legislation in this area along with federal legislation regulating the use of unitary tax systems for franchise and income taxes."[3] The need for Congress to take action has been made even more

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[2] *Comments on Proposed Interstate Sales and Use Taxation Act of 1986*, New York State Bar Association, Tax Section, May 31, 1986.

[3] The nexus issue for business activity taxes clearly affects allocation formulas. See *Fluor Enterprises, Inc. v. Revenue Division, Department of Treasury, State of Michigan*, 477 Mich. 170 (2007), *cert. denied*, 2007 U.S. Lexis 11436 (2007).

apparent by the Supreme Court's recent denial of certiorari for two cases[4] that dealt directly with these issues, possibly signaling that it believes the issue is best resolved by Congress.

This letter also comments on the Business Activity Tax Simplification Act of 2007 (S. 1726) ("S. 1726"), pending federal legislation that would establish "physical presence" as the Congressional standard for imposing a business activity tax on an out-of-state business. We point out certain ambiguities in the language of this statute, and emphasize the need for Congress, when it acts, to be very clear. The passage of an ambiguous tax nexus statute would not solve the uncertainty faced by states and taxpayers under the current state of the law.

Also, the movement of some states toward a single sales factor apportionment formula is an important consideration in light of bills like S. 1726 that would establish "physical presence" as the appropriate standard. State income tax apportionment formulas allocate a taxpayer's national income among the states based on certain factors. In some cases, a combination of factors is used, such as sales, property, and payroll in the state; in others the formula is based solely on sales. For example, if in a single sales factor state a taxpayer makes 20 percent of its sales to customers in that state, then 20 percent of its income will be subject to tax in that state (assuming, of course, the taxpayer has the requisite nexus to the state). If all states were to move toward a single sales factor formula, and physical presence were established as the national nexus requirement, a corporation that produces all of its goods in a state but has all of its customers in other states will have no tax liability in the state in which its production is performed. If this same taxpayer does not have physical presence in the states where its customers are located, such states will not have jurisdiction to tax the taxpayer under their apportionment formulas at all – meaning this taxpayer is taxed nowhere. Thus, as demonstrated by the preceding polar example, the combination of such an apportionment formula with a physical presence requirement could result in many taxpayers avoiding state income tax entirely.

Since the overall effect of the jurisdictional standard cannot be measured without looking to state apportionment formulas, we urge Congress to consider whether establishing a uniform apportionment standard would be appropriate in conjunction with adopting a jurisdictional standard. Whatever jurisdictional standard Congress might impose, the lack of uniformity in state apportionment formulas contributes to the disparate treatment of taxpayers among the states for business activity taxes. It also imposes a significant compliance burden on multistate businesses that are forced to familiarize themselves with a multitude of apportionment formulas.[5]

In addition to the complexity and expense involved in complying with multiple apportionment formulas, the lack of uniformity can result in more than 100 percent of a business's income being taxed (of course it can also result in less than 100 percent of a business's income being taxed). Anomalously, "the only certainty is that it will not be taxed on exactly 100 percent of its income."[6] Establishing uniformity throughout the states with respect

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4 *West Virginia v. MBNA America Bank*, 640 SE2d (W. Va. 2006) *cert. denied*, 127 S. Ct. 2997 (2007); *Lanco v. New Jersey Division of Taxation*, 879 A.2d 1234 (N.J. 2005) *cert. denied*, 127 S. Ct. 2974 (2007).

5 Faber, Peter L., *Should the States Determine Their Own Tax Destinies? Federalism in the 21st Century*, 40 STATE TAX NOTES 11 (Apr. 10, 2006).

6 Id.

to apportionment would be consistent with the Commerce Clause's purpose of limiting state interference with interstate commerce, and the Supreme Court has explicitly stated that such an act is authorized under the Commerce Clause.[7]

We express no opinion about whether a uniform apportionment rule is the correct result, but we urge that whatever result Congress chooses be chosen carefully, and that Congress consider apportionment consequences closely when determining what the appropriate nexus standard should be. A complete discussion of the apportionment issues is beyond the scope of this letter, but we would be pleased to address this issue in a subsequent letter.

Constitutional Nexus Requirements for Business Activity Taxes

The United States Supreme Court's interpretation of the negative or dormant Commerce Clause "has evolved substantially over the years, particularly as that Clause concerns limitations on state taxation powers."[8] In 1977, the Court in *Complete Auto Transit* settled upon the current four part test for determining the constitutionality of a state's imposition of a tax on interstate commerce.[9] A tax will be sustained against a Commerce Clause challenge when the tax: [1] is applied to an activity with a substantial nexus with the taxing state; [2] is fairly apportioned; [3] does not discriminate against interstate commerce; and [4] is fairly related to the services provided by the state.[10] For purposes of sales and use tax, *Quill Corporation v. North Dakota*[11] held that a vendor must have physical presence in a state to establish the "substantial nexus" required by the Commerce Clause in order to obligate the vendor to collect and remit use tax on purchases by the state's residents.

The Supreme Court decisions do not make clear, however, whether actual physical presence of personnel or tangible or intangible property is required for the imposition of a business activity tax.[12] It may be that economic activity by a taxpayer in a state could create sufficient "economic" nexus to subject it to a business activity tax.[13] Some commentators have written that there is a Constitutional requirement that a state provide substantial services to an out-of-state seller before the state can tax the seller. Others disagree. It is not clear whether the

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7 *Moorman Manufacturing Co. v. Bair*, 437 U.S. 257, 280 (1978) ("it is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income.").

8 *Quill Corp. v. North Dakota*, 504 U.S. 298, 309-310 (1992).

9 *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977).

10 Id. at 279.

11 504 U.S. 298 (1992). We believe, consistent with the *MBNA* case discussed herein, that *Quill* does not constrain Congress's ability to adopt a non-physical presence test for business activity tax nexus. In fact, the *Quill* court wrote that Congress has the authority under the Commerce Clause to determine when a taxpayer has sufficient contacts with a state to be subject to tax. Id. at 318.

12 For an interesting discussion of the history of the physical presence test and its applicability to artificial persons like corporations see Baez and Carr, *From Pennoyer to Quill: 20th Century Case Law Provides Understanding of the Physical Presence Test*, Tax Management Multistate Tax Report, Vol. 9 No. 3, Bureau of National Affairs.

13 See, for example, Mazerov, *Should New Limits of State Corporate Profits Taxes be a Quid Pro Quo for the States' Ability to Tax Internet Sales?*, Center on Budget and Policy Priorities, September 4, 2001; and Rosen, *E-Commerce and State Taxation: What's All the Fuss About?*, E-Commerce Law, Vol.1 No. 1, November/December 2000.

proponents of this claim base it on current constitutional principles or whether this is an argument that goes to the "fairness" of a proposed Congressional nexus test.

It is clear, however, that subject to the requirements of the Due Process Clause, Congress could determine nexus requirements for business activity taxes under the Commerce Clause.[14] The Supreme Court has suggested that it is no longer interested in addressing the determination of state tax nexus requirements under the Commerce Clause.[15] On occasion, Congress has acted under the Commerce Clause to overturn tax-related decisions of the courts legislatively,[16] and Congress has passed a number of *ad hoc* statutes that have restricted the states' power to tax discrete activities directly,[17] but to date it has not set forth a national nexus standard.

In the absence of definitive Congressional or Supreme Court nexus guidance, decisions about the nature and extent of the contacts required to satisfy the first ("substantial nexus") prong of the *Complete Auto Transit* test have fallen to the state courts.[18] The state courts have, unfortunately and unsurprisingly, made disparate decisions about nexus requirements in virtually identical factual circumstances. This makes it difficult for taxpayers to derive clear guidance about their tax compliance obligations – particularly in the common situation where a taxpayer does business in more than one jurisdiction. These inharmonious opinions have left businesses and state revenue departments unclear about what the proper Commerce Clause nexus standard for business activity taxes actually is, leading to confusion, inconsistency and considerable litigation. Particularly, the lack of any clear and uniform standard has made it difficult for businesses attempting to meet their filing obligations, and also for state auditors seeking guidance as to when they are justified in issuing an assessment against an out-of-state business.

One particularly stark example of the confusion created by the lack of nexus guidance is the differing application of business activity taxes to credit card issuers in Tennessee and West Virginia.

From February 1990 through January 1994, the J.C. Penney National Bank, a national banking association with its commercial domicile in Delaware, engaged in credit card lending through the issuance of Visa and MasterCard credit cards to residents of Tennessee. During the time period in question, the bank had between 11,000 and 17,000 credit card accounts in Tennessee. None of the activities connected with the bank's credit card lending occurred in Tennessee, except that solicitations to obtain credit cards were sent to residents of Tennessee by mail. All of the entities involved in the credit card business were located outside Tennessee.

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14 *Quill,* supra note 8; *Barclay's Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994).

15 *Quill,* supra note 8 at 319, quoting in part from *Commonwealth Edison Co. v. Montana*, 433 U.S. at 638 "In this situation, it may be that 'The better part of both wisdom and valor is to respect the judgment of the other branches of the government.'"

16 *E.g.*, P.L. 86-272, 73 Stat. 555, 15 U.S.C. 381 et. seq., addressing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) (business activity tax); P.L. 104-88 overturning *Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175 (1995) (tax on interstate bus tickets).

17 E.g. Federal Aviation Act, 49 U.S.C. 40116 ("head taxes" and other taxes on air travel); P.L. 104-95, 4 U.S.C. 114 (taxation of pensions of non-residents); The Mobile Telecommunications Sourcing Act, 4 U.S.C. 116-126 (fixing situs of mobile telecommunication service for tax purposes).

18 This is true for use tax nexus as well as for business activity tax nexus. See, *e.g. Orvis v. Tax Appeals Tribunal*, 86 N.Y. 2d 165 (1995).

The bank maintained no office or place of business in Tennessee and had no employees in Tennessee. The Tennessee Department of Revenue assessed excise taxes, franchise taxes and interest against J.C. Penney National Bank on the grounds that it was "doing business" in Tennessee within the meaning of Tennessee statutes.[19] The Tennessee Court of Appeals[20] held that "merely" "doing business" in the state did not fulfill the Commerce Clause nexus requirements. The court also held that, absent further guidance from the Supreme Court, the appropriate test for nexus was the physical presence test set forth in *Quill*.[21] The court recognized that *Quill* dealt with use taxes and not business activity taxes, but saw no reason not to extend to business activity taxes *Quill's* determination that physical presence is a requirement for substantial nexus.[22]

In 2007 the Supreme Court also denied certiorari in a West Virginia case[23] holding under facts very similar to those presented in *J.C. Penney National Bank,* that sufficient nexus existed to allow the state to tax the business activities of a taxpayer that had no physical presence in West Virginia, but had systematic and continuous business activity in the state, which produced significant gross receipts but had no physical presence in the state.

During 1998 and 1999, the years at issue in the case, MBNA was a foreign banking corporation that had its principal place of business and its commercial domicile in Delaware. The bank had no employees and no real or personal property located in West Virginia, the state that sought to impose an income tax. The bank issued and serviced credit cards and extended unsecured credit to customers who used those credit cards. In 1998, MBNA's gross receipts attributable to West Virginia customers were $8,419,431, and in 1999 its gross receipts attributable to West Virginia customers were $10,163,788. MBNA paid West Virginia Business Franchise Tax and West Virginia Corporation Net Income Tax for the years in question and subsequently filed claims for refund of those taxes. West Virginia statutes provide for statutory nexus for both taxes if a non-resident financial corporation obtains or solicits business in the state from 20 or more persons within the state or if its total gross receipts attributable to sources in the state exceeds $100,000.[24]

In its opinion, the Supreme Court of Appeals of West Virginia noted that it was required to decide only whether MBNA had substantial nexus with West Virginia so as to meet the Commerce Clause substantial nexus requirement set forth in *Complete Auto*. The court discussed at length the physical presence requirement in *Quill*[25] with respect to the collection of use tax by out of state retailers. The Court held that it did not apply to state business franchise and corporation net income taxes because the potential burdens on interstate commerce were different and because Quill was decided principally on the basis of *stare decisis*.

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19 TENN. CODE ANN. §§ 67-4-806(d)(2) and 67-4-903(f)(2).

20 *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (1999), appeal denied (May 8, 2000), *cert. denied,* 531 U.S. 927 (2000).

21 The United States Supreme Court declined to review the case.

22 *J.C. Penney,* 19 S.W.3d at 839.

23 *Tax Commissioner of West Virginia v. MBNA America Bank*, 640 S.E.2d 226 (2006).

24 W.VA. CODE ST. R. §§ 11-23-5a(d) (1996), 11-24-7b(d) (1996).

25 504 U.S. 298 (1992).

The court concluded that "MBNA's systematic and continuous business activity in [West Virginia] produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*."

The court also specifically rejected the reasoning in J. C. Penney National Bank which it conceded was "factually on point and addresses the same issue".

The *MBNA* court wrote that it is "of relevance to the instant case" that bills[26] (all similar to S. 1726) had been introduced in Congress to expand P.L. 86-272 so that it would cover in addition to tangible property, all other forms of property, services and other transactions fulfilled from a point outside the state. The court did not make clear why it believed the introduction of these bills had any relevance to the case, however.

With the Supreme Court abstaining on the issue of tax nexus and with state courts rendering conflicting and irreconcilable decisions, we recommend that Congress act to establish a clear nexus-rule for the imposition of business activity taxes. This would provide certainty to taxpayers and would minimize costly state-by-state litigation and potentially contradictory state court decisions on the same issue. For the reasons discussed below, we further recommend that the standard take into account economic presence, rather than being limited to a pure physical presence test as in *J.C. Penney*.

Policy Considerations for Tax Nexus Standards

We recognize that policy considerations underlie much of the debate between proponents of each jurisdictional standard and accordingly it would be helpful to briefly discuss the major points on both sides. Issues of nexus tax policy are often discussed with reference to three factors: (1) equity, (2) efficiency and (3) administrability.[27]

Equity arguments on this topic often revolve around the "benefits received" theory of taxation; which postulates that taxes should, at least in part, be payments for services received from the government. Disagreement as to how this theory applies to the nexus debate is partly attributable to difficulties in measuring and pricing the benefits received.[28] Proponents of the "physical presence" standard argue that benefits are only received by taxpayers physically present in the state. We find this argument weak, however, since an out of state seller cannot do business in a lawless, disorderly jurisdiction, nor could such business legally enforce obligations of its customers, and therefore the taxpayer benefits from the state's creation of a viable marketplace.[29]

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[26] H.R. 1956, 109th Congress (April 28, 2005); H.R. 4845, 109th Congress (March 2, 2006); S. 2721, 109th Congress (May 4, 2006).

[27] *See, e.g.*, John S. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV 319.

[28] Id. at 374.

[29] Id. at 379.

Economists generally agree that taxes create incentives for taxpayers to engage in economically inefficient behavior that would not take place in an otherwise efficient market.[30] We believe that when considering the appropriate jurisdictional standard, consideration should be given to its economic effect. The "physical presence" standard is often seen as creating artificial incentives for taxpayers to engage in economically inefficient behavior by encouraging taxpayers to avoid being physically present in states in which sales are made.[31] According to some, though, the "physical presence" standard creates beneficial tax competition among the states, forcing states to be more efficient, and allowing taxpayers to choose whether or not to be present in a state based on the government services and taxes.[32]

Proponents of "economic presence" view the standard as being less likely to incentivize inefficient behavior since it is more difficult to manipulate where products are consumed than where they are produced.[33] In addition, an "economic presence" standard would seem to match tax liability with economic reality more aptly than a "physical presence" standard does, since a taxpayer can derive a significant economic benefit from sales in a state without being physically present there.

Administrability arguments focus on ease of enforcement and ease of taxpayer compliance. Proponents of "physical presence" claim that the standard allows taxpayers to determine more easily whether they have nexus in a state. Also, since a taxpayer is likely to be economically present in more jurisdictions that physically present, a physical presence standard reduces the number of states with tax jurisdiction over the taxpayer, thereby also reducing the compliance burden. On the other hand, some argue that, even assuming the "physical presence" standard is easier to administer, it is at the expense of equity and efficiency.[34]

Many also question whether a physical presence test, despite claims that it is a clear bright-line test, is actually easier to administer. U.S. Supreme Court Justice White stated in his dissent in *Quill* (the case establishing a physical presence test for sales and use tax), that the parameters of the supposedly "bright-line" test retained by *Quill* will "be tested to their fullest in our courts," anticipating considerable litigation involving myriad factual situations.[35] "Physical presence" is no more likely to create consistency or predictability in the business activity tax arena than in the sales and use tax arena.

In fact, it may be that, since an "economic presence" standard better reflects economic reality and better relates actual business activity, it is less likely to be subject to convoluted reasoning by the courts. Physical presence is often unrelated to a taxpayer's business activity in a state, and courts are forced to determine tax jurisdiction based on this artificial construct. Because a physical presence test often does not reflect the economic reality of a taxpayer's business, it should not be the sole means of determining business income tax liability.

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30 Id. at 375.
31 Id. at 383.
32 Id. at 388.
33 Id. at 387.
34 Id. at 390.
35 *Quill*, 504 U.S. at 331.

A physical presence standard does not necessarily lead to a more administrable bright-line test than an economic presence standard. An example of the strained analysis that physical presence-like tests can force courts and taxing authorities to apply is seen in a 2005 advisory opinion of the New York Department of Taxation and Finance (the "Department").[36] In this opinion, the taxpayer was a Pennsylvania corporation engaged in the sale of ready mix concrete, and its sales to customers in New York for the years in question were significant, ranging from 15 to 22 percent. Other than a listing in a local New York telephone book and making deliveries of its cement to customers, the company had no contacts with New York. The listing in the telephone book was protected solicitation activity under Public Law 86-272 (explained in further detail below), so the issue the Department had to consider was whether the cement deliveries constituted doing business in New York. According to the Department's opinion, there are two ways to produce ready mix concrete; (1) transit mixed, and (2) central mixed. The transit mix method involves loading the necessary raw materials into a truck mixer and the concrete is produced by the rotation of the mixer while in transit to the delivery location. The production of central mixed concrete occurs prior to loading into the truck mixer, and the rotation of the mixer is simply to keep the concrete from hardening during transport. The Department determined that since the taxpayer used the central mixed method, it was not producing the cement in New York and was therefore not subject to business activity tax. This case illustrates how a pure physical presence standard may have no bearing on economic reality. An economic presence standard or a hybrid standard could well have produced a more certain result due to the sales of the taxpayer in New York.

Recognizing that there are some administrative challenges for determining whether a taxpayer has the requisite economic presence, and recognizing that this standard could increase the number of states in which a taxpayer is required to file, some have suggested the use of a factor-presence nexus standard where a taxpayer will be presumed to have nexus with a state if receipts, property, or payroll exceed certain thresholds.[37] For example, the Multistate Tax Commission (MTC) has drafted a standard under which a taxpayer would be presumed to have nexus in the state if either of the following thresholds is exceeded: (1) $50,000 of in-state property, $50,000 of in-state payroll, or $500,000 of in-state receipts; or (2) a property, payroll, or receipts factor of greater than twenty-five percent. The foregoing MTC test is used solely for illustration, and we take no position on whether it represents the appropriate standard. If a taxpayer's contacts with a state are less than the applicable thresholds, the contacts with the state are considered *de minimis* and will not be subject to business activity tax.

Some have also suggested that a hybrid approach be adopted that incorporates both economic presence and physical presence elements. For example, the above factor-presence test could also include a physical presence element, whereby a state would not have jurisdiction to impose a tax unless a taxpayer was physically present in the state or the taxpayer's economic activity exceeded certain thresholds. Provisions that exempt certain *de minimis* contacts are critical to avoid overwhelming taxpayers with state filing requirements due to relatively minimal contacts with a particular state.

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[36] TSB-A-05(3)C, 2005 N.Y. Tax LEXIS 67.

[37] Swain, 45 WM. & MARY L. REV at 391, which notes that the Multistate Tax Commission (MTC) has drafted such a standard.

Accordingly, we recommend that any legislation adopting a nexus standard also include a reasonable *de minimis* threshold so that the administrative burdens of tax compliance in a state fall only on those taxpayers whose activities linked to the state justify the burden. Although there are administrative burdens with both physical and economic presence standards, we believe that the equity and efficiency considerations clearly favor taking into account economic presence, rather than physical presence alone, and recommend that Congress act accordingly.

An additional consequence of establishing an economic presence standard is that, if universally applied, it would likely increase the number of non-U.S. taxpayers subject to state income tax, even if those same taxpayers are not subject to federal income tax (either because their activities do not rise the level of a U.S. trade or business under Section 871 or 882 of the Internal Revenue Code, or because they are protected by treaty). Therefore, in connection with any nexus legislation, Congress should consider whether or not it is appropriate to apply different jurisdictional standards to non-U.S. taxpayers.

Business Activity Tax Simplification Act of 2007

On June 28, 2007, Senators Schumer and Crapo introduced S. 1726 which would broaden the scope of the Interstate Commerce Tax Act of 1959 (P.L. 86-272) to cover sales of intangible personal property and the service industry. It would also require that a business have physical presence in a state as a dormant Commerce Clause[38] prerequisite to the state's imposition of a business activity tax. S. 1726 has no corresponding bill in the House of Representatives at this point, but one may be introduced in the 110th Congress. Similar bills have been introduced in the House since at least 2001.[39] By and large the bills have been similar with small changes from version to version.[40] The thrust of each bill has been to establish a "physical presence" test for the imposition by a state of business activity taxes. Whether one is in favor of or opposed to a physical presence standard in principle, the numerous ambiguities of S. 1726 demonstrate that if Congress decides to act on this issue, it is important to enact a thorough and clear statute or else the uncertainty among the states will persist.

P.L. 86-272[41] now provides businesses limited protection from net income tax if in-state activity is limited solely to the solicitation of orders for sales of tangible personal property where the orders are sent outside the state for approval and are subsequently filled by shipment or delivery from a point outside the state.

S. 1726 would expand P.L. 86-272 to also protect solicitation of orders for "all other forms of property, services and other transactions." In addition, activities beyond solicitation would be protected, including (1) furnishing information to customers or affiliates, (2) "the coverage of events or other gathering of information" when the information is used or

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38 U.S. Constitution, Article I, Section 8.

39 *E.g.*, H.R. 2526; 107th Congress (July 17, 2001).

40 S. 1726 includes, for example, specific provisions aimed at information gathering and media services, while H.R. 1956, 109th Congress (April 28, 2005) included specific provisions relating to entertainment and sporting events.

41 15 U.S.C. 381 et. seq.

disseminated from a point outside the state, and (3) activities incident to the taxpayer's purchase of goods or services within the state if "the final decision to purchase" is made outside the state.

If Congress decides that continuing the basic scheme of P.L. 86-272 is appropriate to modern Commerce Clause jurisprudence, it should consider whether it is fitting to extend the reach of the statute to other property and services that were, as a proportion of the U.S. economy, substantially less significant in 1959 when P.L. 86-272 was enacted.

S. 1726 would also prohibit a state from imposing a business activity tax on a person unless the person has a "physical presence" in the state. "Physical presence" would be limited to a few enumerated circumstances. First, an individual would be physically present in the state if present in the state for 15 or more days in a year (unless the state provided for a higher number).[42] Second, an employer would be physically present in the state if it assigned one or more employees to the state subject to the *de minimis* daily limit. Third, a person that used the services of an agent to establish or maintain a market in the state would be physically present in the state so long as the agent did not perform business services for any other person during the year. Fourth, a person who owned or leased tangible personal property in the state would be physically present in the state. Finally, physical presence would not include presence in a state to conduct "limited or transient business activity."

The provisions of the bill requiring physical presence would not apply to individuals domiciled or resident in the state or to other persons incorporated, formed or domiciled in the state. Section 3(e)(2) of the bill states somewhat mysteriously that the physical presence rules shall not be construed to modify or affect any state business tax liability of an owner or beneficiary of a partnership, an S corporation, a limited liability company classified as a partnership for federal income tax purposes, a trust, an estate or other similar entity if the entity has a physical presence in the taxing state.

On whole, S. 1726 is an ambiguous bill that serves more as a placeholder for various concepts related to physical presence than as an effective articulation of a Congressional nexus standard designed to give guidance and minimize controversy. Part of the problem is that the bill is in the form of an amendment to a 48 year old statute with a substantial interpretive gloss. Given the current and historic problems associated with interpreting and applying P.L. 86-272, S. 1726's "modernization" of a problematic statute is an inadequate fix to the nexus uncertainty.

Even if Congress determines that S. 1726 represents its view on state taxing authority on the merits, we believe the bill should be substantively revised to clarify its ambiguities, including those noted below. Legislative history explaining the significance of each provision would also be helpful. However, because there is no administrative agency like the Treasury Department that can read the legislative history and issue guidance interpreting the words of the statute, a comprehensive and clear statute is essential.

The addition of intangible personal property and services to the protected sales is fairly obvious and clear in the current economy, but many of the changes proposed by the bill would

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[42] The 15 day period would be prorated for short taxable periods.

make the statute unclear. For example, subsection (a)(1) of the current P.L. 86-272 concerns the solicitation of "orders." The amended version in the bill adds the words "or customers". What is the intended significance of this change? Is there any difference between the use of the word "filled" in proposed subsection (a)(1)(A) and the use of the word "fulfilled" in proposed subsection (a)(1)(B)?

The bill would amend the current statute to cover sales "or transactions." The bill should make clear what is intended by this change, along with supporting legislative history. Proposed new subsection (a)(3) has a special rule for event coverage or information gathering. Thought should be given to crafting a more comprehensive general standard that would eliminate the need for special mention of specific industry groups.

If a physical presence test is adopted, we do believe that defining what physical presence is, as S. 1726 does, is superior to the technique used in some prior bills of defining what physical presence *is not*.[43] The definition of *de minimis* physical presence as "presence in a State to conduct limited or transient business activity" needs more explanation, however. Just what would be the limits? Would the size of a transaction matter? What does "transient" mean in this context? The *de minimis* exception to P.L. 86-272 has been a frequent subject of litigation, and S. 1726 does little to clarify the "trivial" standard set forth in *Wrigley*.[44]

Because the statutory protection proposed in the bill is significantly broader than that found in current law, if this bill is enacted in some form, we suggest that voluntarily registering an entity to do business in a state in order to gain access to state courts or other state benefits should subject the entity to business activity tax nexus. While we recognize that this would be a change from some states' current understanding of P.L. 86-272,[45] this result would be consistent with the theoretical argument of proponents of a physical presence rule that a state should not be allowed to tax a business unless the state provides services to the business. Furthermore, Congress is not restrained by state court interpretations of its own statute and, as we pointed out previously,[46] has acted on several occasions to overturn tax-related court decisions legislatively.

The bill would extend the tax prohibition to business activity taxes in addition to the "net income" taxes prohibited by P.L. 86-272. The actual definition of business activity tax set forth in the bill[47] is confusing, however. The definition covers taxes "in the nature of a net income tax or tax measured by the amount of, or economic results of, business or related activity conducted in the state." It goes on to list and exclude selected other taxes such as sales taxes or use taxes or

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43 *See, e.g.,* H.R. 2526, 107th Congress (July 17, 2001).

44 *Wisconsin Department of Revenue v. Wrigley*, 505 U.S. 214 (1992) (even activity exceeding the solicitation of orders may not cause a company to lose its tax immunity if the activity establishes merely a *trivial* connection with the taxing state).

45 *See, e.g., Kelly-Springfield Tire Co. v. Connecticut Commissioner of Revenue Services*, 635 A.2.d 771, 777 (Conn. 1993); *Massachusetts Commissioner of Revenue v. Kelly-Springfield Tire Co.*, 643 N.E.2d 458 (Mass. 1994); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. – Austin 2000) (considering the analogous question of whether registering as a vendor in a state creates nexus under the Commerce Clause or Due Process Clause for purposes of sales and use tax collection purposes)

46 *Infra* notes 16 and 17.

47 Section 3(g)(2).

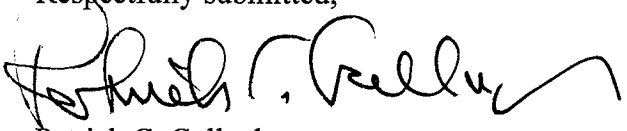
similar transaction taxes imposed on the sale or acquisition of goods or services, regardless of whether denominated a tax imposed on the privilege of doing business. Could states in their quest for revenue attempt to circumvent the statute by characterizing a tax as a "sales tax" on gross receipts which would then be governed by more lenient physical presence standards then those set out in the statute?[48] Regardless of whether a state characterizes a particular tax as a sales tax or an income tax, any tax based on gross receipts could in actuality be a sales tax, an income tax, a value added tax or some other kind of tax with the appropriate combinations of deductions, exemptions and allowances.

Conclusion

We recommend that Congress exercise its right under the Commerce Clause and adopt a clear nexus standard for business activity taxes to guide taxpayers and state and local taxing authorities and to minimize controversies. We further recommend that this standard (1) take into account "economic presence" rather than (like S. 1726) being limited to a pure "physical presence" test, and (2) also include a reasonable de minimis threshold so that the administrative burden of tax compliance in a state fall only on those taxpayers whose activities linked to the state justify the burden. We urge that any legislation adopting a nexus standard be carefully and clearly drafted and accompanied by a detailed legislative history that explains how the statute relates to the almost 50 years of judicial and legislative pronouncements on the issue. If and when Congress decides to act on this issue, regardless of the standard chosen, we are available to assist in developing the appropriate statutory language.

It is also clear that use tax and business activity tax nexus issues and the movement toward single sales factor apportionment statutes all impact both the states' ability to raise revenue and the ability of multi-state and multinational businesses to remain competitive. For these reasons, Congress might consider whether it is appropriate to address both nexus issues and the effect of various state allocation formulas at the same time, including whether it is appropriate to establish a uniform apportionment formula. Particularly given the increasingly nationwide markets of even small businesses, we believe Congressional action is critical to clarify the authority of the states to impose these taxes.

Respectfully submitted,



Patrick C. Gallagher
Chair

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[48] See for example, the test for physical presence set forth in *Orvis v. Tax Appeals Tribunal*, 86 N.Y. 2d 165 (1995).

cc:

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