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HOW MUCH SHOULD BORDERS MATTER? TAX JURISDICTION IN THE NEW ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

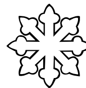
COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

JULY 25, 2006



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HOW MUCH SHOULD BORDERS MATTER? TAX JURISDICTION IN THE NEW ECONOMY

TUESDAY, JULY 25, 2006

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:34 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Craig Thomas, (chairman of the subcommittee) presiding.

Present: Senators Snowe, Crapo, and Bingaman.

OPENING STATEMENT OF HON. CRAIG THOMAS, A U.S. SENATOR FROM WYOMING, CHAIRMAN, SUBCOMMITTEE ON INTERNATIONAL TRADE, COMMITTEE ON FINANCE

Senator THOMAS. I call the meeting to order. Thank you all for being here. I think it is an important issue we are talking about this morning, so I am very pleased to have the opportunity to join with you in examining some of the important and complicated tax jurisdictional issues that are before us.

We have an outstanding slate of witnesses here today to share their views regarding State tax jurisdiction and the impact of interstate and international commerce in the context of Internet tax and business activity taxes. We will address both of these issues today. We will handle these issues separately by devoting a separate panel to each.

All witnesses will be limited to 5 minutes for their introductory remarks, and your written statements will be included in the record, without objection. I look forward to your comments.

We begin today with the issue of Internet taxation. The dramatic rise in Internet sales over the last decade has called into question the historic standard that a business must be located within the State in order for the State to be able to require the business to collect sales taxes on its behalf.

Currently, if a State resident makes a purchase from a remote vendor and sales tax is not collected, the purchaser is required to remit the tax directly to his home State. Of course, this is almost impossible for the State to enforce.

The States have proposed shifting the collection burden to the remote seller in the case of Internet sales, but current law does not allow this.

Additionally, Internet sellers have cried foul on the basis of complexity resulting from thousands of different tax jurisdictions within the various rates, definitions, and procedures.

The States have attempted to address these problems by coordinating, through the Streamlined Sales Tax Project, to try to achieve some uniformity. The question we have today—or questions we have—are: (1) is it appropriate to shift the sales tax collection burden; (2) if so, how much simplification is enough so that the sellers will not be unduly burdened in the conduct of their interstate commerce?

Kicking off the discussion, I am pleased to welcome my friend and colleague from the great State of Wyoming, Senator Mike Enzi, who has introduced a bill on this subject and of course has been very involved in it.

So, Senator Enzi, welcome, friend. Please go ahead with your testimony.

STATEMENT OF HON. MICHAEL B. ENZI, A U.S. SENATOR FROM WYOMING

Senator ENZI. Thank you very much, Chairman Thomas. I thank you for allowing me to testify on this issue of the importance of imposing uniformity, simplification, and fairness concerning the taxation of remote sales over the Internet. I appreciate you and Senator Bingaman holding this hearing today to discuss this crucial issue.

As a former small businessman and mayor, I have some definite appreciation for this issue. Of course, small business throughout the country already has to collect this tax.

People in small towns, and even large towns, rely on those businesses to contribute to the local charities, to buy the yearbook, to pay for town events. That is something that the out-of-town folks do not have to help on.

As a mayor, I also know that you cannot flush your toilet over the Internet. I know that you cannot drive an automobile on the Internet. I know that kids do not get much of a kick out of playing in a virtual city park, and it is not quite the same atmosphere if they are at a virtual picnic.

So, there are a lot of things that cannot be done over the Internet, and local governments rely on that revenue in order to be able to provide the things you cannot do over the Internet.

Now, I know that local government has been a part of the problem because there are a lot of jurisdictions. That is what streamlining the sales tax is about, so there is not a rate for every single community and every single county, and so you do not have to send out thousands of checks every month.

The cities, towns, counties and States have done a marvelous job of coming together to recognize that kind of a problem and put some streamlining in there.

Now, I have worked on this issue since joining the U.S. Senate in 1997. Most recently, in December of 2005, I introduced S. 2152, the Sales Tax Fairness and Simplification Act, a bill that will level the playing field for all retailers, in-store, catalog, and online so an outdated rule for sales tax collection does not adversely impact small businesses and Main Street retailers.

By addressing the collection inequity, the bill will also ensure the viability of the sales tax as a major revenue source for State budgets by closing a growing loophole that encourages tax avoidance.

Now, this bill is not about new taxes. In fact, dependency on Federal dollars, as you said in your opening comments, would be offset by increases in State revenue.

At a time when States increasingly turn to the Federal Government for financial support, Congress should authorize States to systematically and fairly collect the taxes already owed them. This is not a new tax.

As the Supreme Court identified in *Quill vs. North Dakota,* a multitude of complicated and diverse State sales tax rules makes it too onerous to require retailers to collect sales taxes unless they have a physical presence in the State of the buyer.

So local brick-and-mortar retailers collect sales taxes, while many online and catalog retailers are exempt from collecting the same taxes. This is not only fundamentally unfair to Main Street retailers, most of whom are small businesses, but it is costing States and localities billions of dollars in lost revenue.

S. 2152 will help relieve this burden by requiring States to meet the simplification standards outlined in the Streamlined Sales and Use Tax Agreement. Working with the business community, the States developed the agreement to harmonize State sales tax rules, reduce the paperwork burden on retailers, and incorporate new technology to modernize many administrative procedures.

Thirty-four States and the District of Columbia approved this historic agreement on November 12, 2002. Already, 19 States have enacted legislation to implement the agreement, and over 350 businesses—350 business—have signed up to collect sales tax voluntarily under the simplified set of rules.

Now, while the States have made great progress, the *Quill* decision held that allowing States to require collections is an issue that "Congress may be better qualified to resolve, and one that it has the ultimate power to resolve."

The States have acted. It is now time for Congress to provide the States that enact the Streamlined Sales and Use Tax Agreement with authority to require remote retailers to collect sales taxes just as Main Street retailers do today.

Senator Byron Dorgan of North Dakota and I worked tirelessly to assist sellers and State and local governments to find true simplification in sales and use tax collection and administration.

Although Senator Dorgan and I introduced separate bills, we will continue to work with each other and all interested parties to find compromise on the outstanding policy issues. States need to have the authority to collect sales or use taxes equally from all retailers. Adoption of the agreement and Congressional authorization will create a level playing field among all retailers.

Thank you again, Chairman Thomas, for the opportunity to outline the importance of S. 2152. I look forward to working with you, your staff, and the rest of the Finance Committee on this policy initiative in the future to assure swift passing of S. 2152. Thank you.

Senator THOMAS. Thank you very much.

[The prepared statement of Senator Enzi appears in the appendix.]

Senator THOMAS. Senator Bingaman has joined us. I will see if he has a comment before the Senator leaves.

Senator BINGAMAN. Let me just thank Senator Enzi for his leadership on this. I agree with the goal that he has outlined for this legislation, which is to have the same rules with regard to collection of taxes apply to brick-and-mortar operations that apply to people who are selling over the Internet. I think that is a worthy goal, and I hope we can make progress here in Congress to assist it in happening. Thank you.

Senator ENZI. Thank you very much.

Senator THOMAS. Thank you, Senator. We appreciate your efforts and look forward to working with you.

Senator ENZI. Thank you.

Senator THOMAS. I will now turn to our second panel of experts on the topic, two of whom, I am pleased to say, are from my home State of Wyoming.

We have Mr. Daniel Noble, Excise Tax Administrator, Wyoming Department of Revenue; Mr. George Isaacson, partner, Brian & Isaacson, from Lewiston, ME; the Honorable Christopher Rants, Speaker, Iowa House of Representatives; Robert Benham, owner and proprietor, Balliet's LLC, Oklahoma City; and Mr. Gary Imig, executive vice president and chief financial officer, Sierra Trading Post, Cheyenne, WY.

Gentlemen, thank you so much. We appreciate your being here. Again, we ask that you try to summarize your statement if you can within about 5 minutes, and your total statement will be put into the record.

So we will begin right there. We will begin with you, Mr. Noble, if we may.

STATEMENT OF DANIEL W. NOBLE, EXCISE TAX ADMINISTRATOR, WYOMING DEPARTMENT OF REVENUE, CHEYENNE, WY

Mr. NOBLE. Thank you, Mr. Chairman.

My name is Dan Noble. I am the Administrator of the Sales and Use Tax Division for the Wyoming Department of Revenue. I have been a member, if you will, or a participant, in the Streamlined Sales Tax project since its inception.

I think that at current standing there are 42 States and the District of Columbia that are attempting to adopt a simplification effort that involves both the modernization of the Sales Tax Code as well as the simplification of the Sales Tax Code and provides some common ground for all vendors, not just Internet vendors and not just catalog vendors, but all vendors in this country.

To this date, we have achieved some of those goals, a majority of them, actually. We have adopted an agreement, as of November 12, 2002, that basically provides some fairly radical simplifications of different aspects of the Sales Tax Code in this country.

One of the issues that has been probably at the forefront of this has been the issue associated with multiple rates and multiple jurisdictions within this country. There are, currently, roughly 7,500 different jurisdictions within the United States, each imposing potentially a separate tax, as it will, or a different rate.

The States, early on in the project, attempted to deal with the issue of multiple rates and tried to basically come to some sort of a compromise associated with this on how to minimize the number

of jurisdictions, but also remove the burden, if you will, on any remaining jurisdictions from the businesses that have to collect this tax.

What we noted early on was that asking jurisdictions to give up their authority to collect the tax not only created hardship for them, but also dealt with some issues of autonomy as it relates to their ability to impose a tax on their citizenry.

So what we felt was that it was important for the States to assume that burden. We turned to technology, if you will, to basically deal with that issue. To date, there is a technological model in place to deal with the multiple tax jurisdictions that are out there.

It has been a partnership between the States and what we call certified service providers to develop a system that will provide accurate reporting of taxes to the vendors so they can collect this tax.

As of the 20th of July, the State of Wyoming received its first simplified electronic tax return from a certified service provider. Not a lot of money, but the fact is, it is up and it is running. There are currently three vendors that have been certified by the States to collect this tax.

But technology is not the only area where we have attempted to deal with this. The States have taken it upon themselves, as one of the requirements of this agreement, to ensure State-level administration of the tax. They have dealt with issues under audits to try to simplify the audits that are out there.

One of the things that happened early on in this process that really brought home to me the complexity that we have built into this is, there is testimony that one of the major taxpayers in this country was actually paying 600 different tax returns a month.

Now, that is burdensome. By adopting State-level administration and consolidated returns, you reduce that burden from 600 to 46, if this works in all States; major simplification for a lot of vendors that relates to State-wide administration of the tax.

Currently, some States have local jurisdictions that each impose, not only their own tax, but also impose their own administration of that tax. Audits can come from everywhere. This agreement does deal with that issue.

Sourcing rules. This was an issue that was raised by an awful lot of businesses as a major complexity. They did not know what rate to charge. The agreement has some very specific and detailed sourcing rules in it that are being adopted by the States that are out there that are members of the agreement.

Wyoming is an associate member. The reason we are an associate member is because I missed, in drafting the bad debt provisions, this one simple clause associated with when the sale occurs. So we are being very strict about the adoption of those rules.

I guess what it all boils down to is, we have made significant progress towards achieving these goals. But what really has to happen here, the States need guidance. We need to know, how simple is simple enough?

Governor Freudenthal supports this project, but believes that we need action from Congress to let us know how we are doing, number one. Is this simple enough in order to require collection of all vendors? If not, we need guidance on what we need to do to reach

that goal because, frankly, there is a huge amount of revenue being lost by the States.

The estimates vary widely as to how much that actually is, but I think intuitively we should all recognize that there is a significant amount of revenue drain on the States based on conversion from a brick-and-mortar economy to an electronic economy.

Thank you.

Senator THOMAS. Thank you very much, Mr. Noble.

[The prepared statement of Mr. Noble appears in the appendix.]

Senator THOMAS. Mr. Isaacson?

STATEMENT OF GEORGE S. ISAACSON, PARTNER, BRANN & ISAACSON, LEWISTON, ME

Mr. ISAACSON. Thank you, Senator Thomas and Senator Bingaman. My name is George Isaacson. I am tax counsel for the Direct Marketing Association, and I am also a professor of constitutional law at Bowdoin College in Maine. I appreciate the opportunity to speak to this very important issue today.

I think it may be useful to put a historical perspective on the question that you teed up for us at the beginning of this hearing, Mr. Chairman, which is: how much simplification is enough?

It is important to understand that the Streamlined Sales Tax Project was built upon two prior projects that proceeded it. One of them was the National Tax Association's project on taxation of electronic commerce, and the other was the Advisory Commission on Electronic Commerce that was appointed by Congress.

Both of those bodies decided that the key element for simplification of remote taxation is to have one tax rate per State for all commerce. Now, what is really significant about the National Tax Association project is that it consisted of a steering committee of 26 members, half of which were representatives of State government organizations that included the National Conference of Mayors, it included the National Governors Association, and it included the National Conference of State Legislatures.

Unanimously, all of the representatives from industry and from these State government organizations agreed—and passed as a resolution of that body—that any simplification should involve one tax rate per State for all commerce to be divided then by the State as it may choose between municipalities and the State government.

When the Streamlined Sales Tax Project began in 2000, it started out with very elevated objectives, very high ambitions, and even included consideration of the issue of one tax rate per State for all commerce. That was quickly rejected because it was opposed at that time by the representatives to the project.

Suggestions, for example, that there should be a home State audit similar to the International Fuel Tax Agreement, where a company would be audited by its home State and would be remitting tax returns to its home State, was suggested, a real measure for simplification. It was rejected.

The idea of having real uniformity of tax basis was presented and proposed, including by the Direct Marketing Association, and it was rejected.

So what really happened in the period of time between the beginning of the project in 2000 and the reaching of an agreement

among the States—not among the States and industry, but among the States—was changing from the high-bar reform that the project started out with to low-bar reform, procedures that have to do with things like filing arrangements, but not dealing with the substantive issues.

The fact of the matter is, our Federal system of government works very well as long as States restrict their taxation prerogatives to their own territorial borders. That is the subject of the hearing today: do borders continue to matter?

Each State is an independent civic laboratory, including in the tax field, as long as it stays within its borders in the exercise of its jurisdiction. But when it exports its tax authority across State jurisdiction lines, the result is that you have 50 different States applying their tax systems to companies located in 49 other States. Not only is it chaotic, but it is unfair. It amounts to taxation without representation.

There is always the temptation on the part of State governments to hit hardest taxpayers who do not vote. You see that in things like high taxes on summer property, vacation homes, high taxes on tourism, taxes on lodging, car rental, and meals. That is fine as long as the State is restricting that exercise to its own territory.

But when a State exports its tax system across State lines to companies that have no presence in that State, no political exercise of authority within that State, the problem becomes much more difficult.

As an attorney who practices regularly in this field around the country, there is a term that is associated with what happens when an out-of-State company goes into a State and has an administrative appeal. It is referred to as "home cookin'." You get a good dose of "home cookin'" by those local State tax administrators who know that it is extremely expensive and politically abandoned for a company to be contesting procedures.

Now, in regard to that issue, early in the process the proposal was presented to the Streamlined Sales Tax Project that if a nonresident taxpayer objects to a tax on the basis that it violates Federal legislation, such as the legislation that you would be considering, or that it violates the taxpayer's Federal constitutional rights, they should be able to go into Federal court to protect their interests to object to that taxation.

But because of the Tax Injunction Act, that is currently not possible. The suggestion was made that that should be repealed as part of any such proposal, and the States loudly objected.

It follows a pattern, Mr. Chairman. The pattern is, when the States are asked for true high-bar reform, such as one rate per State for all taxes, or Federal court jurisdiction over constitutional claims, the States shout that that is a violation of their tax sovereignty.

The problem, in my opinion, is that the States cannot have it both ways. The States cannot shout "State sovereignty, State rights" when the effort is to have true high-bar reform and Federal review of unconstitutional assessments, and then at the same time say, "We nonetheless want to expand our tax jurisdiction."

The final point that I want to make is that, even with the low-bar reform that is associated with the Streamlined Sales Tax

Agreement, what the States have done since its enactment is to game the system.

So, for example, what States are doing is, they are simply renaming taxes that previously were sales taxes and calling them by a different name. For example, both Minnesota and New Jersey are both member States in the Streamlined Sales Tax Agreement and have flagrantly violated the provision that clothing is either to be taxed or not taxed.

That was supposedly one of the categorical goals of the project. What they have simply done is, they have taken subcategories of clothing and called them an excise tax and continue to apply that tax on gross receipts in the same fashion.

The same thing is true in regard to tax rates. What the State of Tennessee has done is to adopt special user privilege taxes on articles that previously were subject to sales and use tax.

The fact of the matter, Mr. Chairman, is that the States, even in this early stage when they are coming before your committee and asking for relief from existing constitutional restrictions, are already gaming the system to get around the requirements of the agreement. It would be dangerous to liberate the States to increase that adventure in the future.

Senator THOMAS. Thank you, Mr. Isaacson.

[The prepared statement of Mr. Isaacson appears in the appendix.]

Senator THOMAS. We have been joined by Senator Snowe. Did you have any statement, Senator, before we go on with questions?

Senator SNOWE. Thank you, Mr. Chairman. I will ask unanimous consent to include my statement in the record.

But I want to welcome one of my constituents, George Isaacson, who is also a friend who has had a distinguished legal career in Maine, from my home town area of Lewiston, ME, who represents the Direct Marketers Association. He is one of the legal experts—an outstanding legal expert—on the use tax, sales tax, and all the issues we are referring to and addressing here today.

So I want to welcome you, George.

Mr. ISAACSON. Thank you.

Senator SNOWE. Thank you.

[The prepared statement of Senator Snowe appears in the appendix.]

Senator THOMAS. All right. Thank you very much.

Mr. Rants?

STATEMENT OF HON. CHRISTOPHER RANTS, SPEAKER, IOWA HOUSE OF REPRESENTATIVES, DES MOINES, IA

Mr. RANTS. Good morning, Chairman Thomas, Ranking Member Bingaman, Senator Snowe. I am Christopher Rants. I am the Speaker of the Iowa House of Representatives, and I serve as co-chair of the National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce.

I am pleased to have the opportunity to speak with you this morning about State and local taxation in the new economy, specifically the ability of State and local governments to collect the sales and use taxes presently owed on transactions through remote

sellers—not taxes on remote sellers, but taxes through remote sellers.

Let me make this very clear. State legislators are not advocating any new or discriminatory taxes on electronic commerce. We desire, however, to establish a streamlined sales and use tax collection system that is seamless for sellers in the new economy and respects the sovereignty of States' borders.

Today, States face a growing threat to sales tax revenue. It is an important revenue source for State and local governments. The growth of electronic commerce has the potential to dramatically expand the volumes of goods and services sold to customers without the collection of a State sales or use tax that is presently owed.

According to the Center for Business and Economic Research at the University of Tennessee, in 2003 the estimated combined State and local revenue lost due to remote sales was about $16 billion. For electronic commerce sales alone, the estimated revenue loss was almost $8.5 billion.

The report further estimates that the revenue loss will grow, and that by 2008, the revenue loss for State and local governments could be as high as $33.6 billion, of which it is estimated $7.8 billion would be from sales over the Internet.

A recent national survey conducted by the Joint Cost of Collection Study, a public/private sector group, that was conducted by PricewaterhouseCoopers has shown that, in fiscal year 2003, the total cost to sellers to collect State and local sales tax was almost $6.8 billion.

The burden on retailers to comply with the 46 different sales tax systems and the monetary cost to retailers for compliance resulted in two Supreme Court decisions: *Bellas Hess* in 1967, and *Quill* in 1992, that affirmed the States' authority to tax transactions made by the States' residents through remote sellers, but prohibited a State from requiring an out-of-State seller from collecting the sales tax on a purchase made by a resident of the State.

Beginning in 2000, State legislators, Governors, and tax administrators, along with representatives of retailers and others in the private sector, started the process to develop a simpler, uniform, and fairer system of sales and use taxation that removes the burden imposed on retailers, preserves State sovereignty, and levels the playing field for all retailers and enhances the ability of U.S. companies to compete in today's global economy.

By 2002, delegates from the States formulated and finalized the Streamlined Sales and Use Tax Agreement. As of today, all of the sales tax States, except for Colorado, are participating in the ongoing process to simplify sales tax collections.

The key features of the agreement are: simplification of sales and use tax laws and administration; the use of technology for calculating, collecting, reporting, and remitting the tax; and the State assumption of the cost of collection for remote sellers.

Some of the key simplifications contained in the agreement, as adopted by the States, are: uniform product definitions, uniform State and local tax bases, requirements for State central administration, central seller registrations, simplified exemption administration, uniform audit procedures (which we believe would reduce the number of audits), and, of course, uniform sourcing.

Since the agreement was ratified in November of 2002, 21 States have enacted legislation to bring their sales tax statutes' administrative rulings into compliance with the agreement.

On October 1, 2005, 13 States, including my own State of Iowa, were certified to be fully in compliance with the agreement, and with this action the Streamlined Sales Tax system is operational.

Since that October 1 start date, my small State has already collected over $2.6 million in previously uncollected revenue that was owed. The States, through the Streamlined Sales and Use Tax Agreement, have provided Congress with the justification to allow States that have complied with the agreement to require remote sellers to collect those sales taxes as was intended in the *Quill* decision.

The Sales Tax Fairness and Simplification Act, S. 2152, as introduced by Senator Enzi of Wyoming, embodies the simplification requirements of the Streamlined Sales and Use Tax Agreement and provides certainty for taxpayers, retailers, and other businesses that the States cannot backtrack on simplification, but, if we do, the prohibition of the *Quill* decision will be reinstated.

Our work to establish a truly seamless system is only half done. It is now Congress' turn to act. I believe we are at a point that, if Congress fails to act soon on the Federal legislation, as envisioned in the Sales Tax Fairness and Simplification Act, the momentum in the remaining States will slow.

In some of those States, compliance to the agreement may require politically difficult changes to sales tax statutes. I can speak first-hand to the difficulty of accomplishing that. Congressional approval of this legislation will help those legislatures and those States make the necessary changes.

States have made unprecedented progress to eliminate the burdens and costs to retailers that the *Quill* decision outlined. It is now Congress' opportunity to ensure that the simplified system that the States have developed for the seamless collection of transactional taxes in the new economy is not impeded by those who merely try to avoid paying legally imposed taxes.

Thank you very much for the opportunity to present to you this morning.

Senator THOMAS. Thank you, sir.

[The prepared statement of Mr. Rants appears in the appendix.]

Senator THOMAS. Mr. Benham?

STATEMENT OF ROBERT BENHAM, OWNER/PROPRIETOR, BALLIET'S, LLC, OKLAHOMA CITY, OK

Mr. BENHAM. Thank you, Mr. Chairman.

My name is Robert Benham. I am an independent retailer from Oklahoma City. I am the owner/proprietor of Balliet's in Oklahoma City. We are a bricks-and-mortar store, and we also have an Internet presence and are experiencing wonderful growth on the Internet.

I am here today on behalf of my business, and other small businesses like mine, as well as on behalf of the National Retail Federation.

I have served on the NRF board for 25 years, and I am here to comment as a small business owner and to share my unified posi-

tion with NRF's in support of Senate bill 2152, the Sales Tax Fairness and Simplification Act introduced by Senator Enzi. We very much appreciate your attention to this critical matter.

Many of the topics, the technical topics and the reasons for this, the background, the history, have been covered. I would like to depart from my written testimony, which is a matter of record, to talk more from out there on the front lines, from the battleground. What do I think about when I go to work in the morning, what do I see as the threats to our business?

First of all, there are stores like ours literally at every crossroads in the United States. Senator Enzi mentioned, we are the backbone of our communities in so many ways. I certainly do not need to review that in any detail. We are very much a part of the fabric of our communities.

We see two major threats to our business as a small, independent retailer. Two strategic threats. One is the constantly escalating cost of health care, which is a separate, but somewhat related, subject. The second is the non-negotiable price disadvantage we face against remote sellers from out of State.

I can tell that in terms of competing in the retail business, there are no borders. We have competition from catalogs, Internet, telephone, from all over the United States. We did sales last year on our website through our e-mail marketing program.

We sold to customers in 34 States last year, and we are a small store in Oklahoma City. We see passage of this legislation enabling us to unlock another whole path of growth for our business, and that is through remote sales.

The subject that has been brought up is, is collecting the tax a burden? Chairman Thomas, I believe you raised that. The answer from my chair is, we do not see that as a burden.

Retailers like Balliet's, in all the States that I know of that have the sales tax, are the tax collectors for the State. We have been doing that for years and years. We have the software to do that. It is pretty seamless at this point. We know how to do that.

As long as we are provided with the software and there is simplification, I see no burden on the retailers in collecting this remote commerce tax and remitting it to the taxing jurisdictions. We are going to have certified software. We can download that certified software.

If we are not able to do it, if a retailer is too small or does not have that capability in-house, they can always out-source it to a certified service provider. Provided that there is compensation for the collection of these taxes, there will simply be a pass-through cost for the retailer and we will be in compliance with the law.

What I love about this as a retailer is that this creates certainty. If we can have legislative certainty and not have to resort to litigation to solve this on a State-by-State basis, I see Internet Commerce and other types of remote commerce as a tremendous commercial growth vehicle for my business.

It literally moves me outside the four walls of my store and enables me to compete on a national basis with certain rules of sales taxation. Right now, we do not really push that because we are concerned about our liability.

But once SST is in place and once the legislation is in place, I see no problem with stores like Balliet's becoming much more aggressive, and growing our business and collecting more sales taxes that are remitted to our communities to support services in communities, and enable us to continue to be such an important part of our communities.

We are very excited about the possibilities for our business, and for many other small businesses. I know lots of other business owners. I am in touch with a lot of them.

I belong to two or three different comparison groups that meet once a year. We are all very excited about the possibilities of this type of commerce. We are not afraid of it.

We are not back in the horse-and-buggy age. We are on top of our business. We are always looking to create new business models that will enable us to compete successfully.

Balliet's has been in business for 70 years this year; I have been in the business for 40 years. I have been through floods, fires, tornadoes, business downturns, economic booms, economic busts, oil booms, oil busts. If you constantly create your business model, if you adapt and if you compete, you can do so very successfully.

The other thing I just want to mention, because I understand there is some discussion about it or some disagreement about it, is something called the small business exemption. I understand there have been different numbers floated on the small business exemption.

Personally, as an operating proprietor of a retail business, I see no need for the small business exemption beyond an introductory period. We all either have the capability, or we will be provided with the capability to collect and remit this tax.

Let us level the playing field. Let us eliminate the competitive disadvantage that we all have, and let us compete. This is the American free enterprise system. Small retailers understand that. We are fierce competitors. So, please provide us with a legislative solution so that we can get on with the business of our business.

Mr. Chairman, members, thank you very much.

Senator THOMAS. Thank you very much.

[The prepared statement of Mr. Benham appears in the appendix.]

Senator THOMAS. Mr. Imig?

STATEMENT OF GARY IMIG, EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, SIERRA TRADING POST, CHEYENNE, WY

Mr. IMIG. Good morning. It is an honor to submit my testimony in regard to Internet taxation at the Subcommittee on International Trade.

I am Gary Imig, the executive vice president of the Sierra Trading Post. Sierra Trading Post is a 20-year-old direct marketing company founded in 1986 by Keith and Roberta Richardson.

We currently employ 800 people in three separate locations in Wyoming and Nevada. We have close to three million customers across the U.S. We also sell our products in several foreign countries. We will mail approximately 60 million catalogues this year.

Our website, on average, gets close to 75,000 unique visitors per day, and our revenue from the website ranks us as the 75th-largest retail website, by revenue, in the *Internet Retailer Top 500 Guide.* Even with all of this, we are a very typical mid-range small business.

I feel it is very important for me to be here today to present my testimony to help protect and nurture the direct marketing industry, an industry that I deeply care about.

When I refer to the direct marketing industry, I am referring to both sales through a catalog and sales through the Web. These two areas have blended so much over the last several years that they have become one in many ways.

I believe the direct marketing industry is one of the last truly great industries that encourages entrepreneurial risk-taking. The evolution of the Internet, in conjunction with catalog mailings, has allowed many under-capitalized entrepreneurial people with good ideas to form companies.

The good thing about these start-ups is they can happen anywhere, from the farms of Kansas to the inner city neighborhoods of Detroit. The Internet has allowed many of these companies to compete with much larger companies on a level playing field.

The creativity and imagination currently coming out of our industry is breathtaking. Almost daily, Sierra Trading Post is reinventing the way we sell to our customers. It is a very exciting, but also very dangerous, time.

Many direct marketing start-ups occur every day. Sadly, many also cease to exist every day. Several years ago, I had the pleasure of listening to a speech that Mike Sullivan, a Governor in the State of Wyoming, gave to a group that I was part of. This was right after he had finished his two terms as Governor.

He talked about the homogenization of America. He and his wife had recently taken some time off to travel America, and he was shocked at how different areas of the country looked so much the same.

From the Interstates, everything looked eerily similar. Of course, there was always a McDonald's. Also, there was always a Wal-Mart around the corner, and all the usual examples. There were grocery store chains, fast food chains, shoe store chains, discount store chains. There were chains for everything.

Mike wondered what had happened to the uniqueness of America. I agree with him. America did not become great, and its economy did not become great, by being the same. This uniqueness is what I believe our industry offers the consumer.

Our entrepreneurial thoughts encourage freshness and creative product offerings. We would not exist as companies if we could not somehow differentiate ourselves from the very large companies that occupy the consumer retail space.

Sierra Trading Post could never compete with a Wal-Mart or Target. Sierra competes by how we service our customers, the uniqueness of our product offerings, and how our low-cost direct marketing structure works.

This entrepreneurial explosion of the direct marketing business on the Web has not been lost on the very large retail companies in the retail space. All of a sudden, large retail chains which have

squeezed their markets to the point where small businesses can no longer compete against them for a retail consumer are now faced with a whole set of new competitors.

These competitors are quicker and more flexible. They take care of their customer better, and in a lot of ways, pay much better attention to the needs of their customer. These new, quicker competitors have begun to take market share from these retailers.

So how did these large retail companies react to this competitor? I submit to you that my being here in front of this committee is one of the results of how big retail and its allies felt they needed to address this competitor. The statement that is always made by the retail industry is, you need to level the playing field. Make them charge taxes like we do.

Of course, what these interests do not mention is that we charge shipping charges, which in most instances are greater than sales tax. We do not have a competitive advantage in this area, and they know it. They know that if we have to charge sales tax up front, we will probably have to cut our shipping charges to make our offerings attractive to the customer.

In this day and age of ever-rising fuel charges and postal rate increases, this substantially impacts our bottom line. This could also have a significant impact on the new start-ups in our industry and overall growth. They know this, and that is why they are pushing it.

There is one significant fallacy in this debate about Internet taxation. Many people think that players in this debate are very large companies. If you look at the top 500 retail websites in the U.S., you will see very quickly that this is not true.

This might be true with the top 50 sites, but after the top 50 sites you are getting into typical small business territory. If it is not a small business, then it is probably a company that not only has a website, but a lot of retail locations already paying sales tax.

A look at the top 50 sites would include such companies as Office Depot, Staples, Office Max, Sears, K-Mart, Best Buy, Wal-Mart, J.C. Penney, Target. All of these entities are probably paying sales tax because of their physical locations.

It is very important to keep in mind, when anyone starts talking about Internet taxation and its effects, they are not talking about big business. Make no mistake, this is about small business.

This is about the creativity of small business and the development of jobs and small business. In fact, the 500th-largest retail website on the Internet Retailer Top 500 website list has only $3 million in sales from the Web.

So how do we address the issue that is before us today? First and foremost, I would suggest caution. This is not just about sales tax leakage. In fact, in my opinion the leakage is overstated.

If you eliminate from the debate large retailers or a very large Web peer place like Amazon or eBay, that leaves about $15 to $20 billion in sales a year generated by the remaining top 500 retail websites.

This seems like a lot, but in my opinion it adds up to about $1 billion per year in sales tax revenue leakage. Dividing this up between all the U.S. tax authorities does not give much to each.

Instead, this discussion, and issue, is about small business. It is about maturing, small entrepreneurial start-ups. This discussion is about recognizing that we want unique offerings for consumers, not to homogenize the offerings we as a country are quickly rushing toward.

This is about job creation. It is about creating jobs in areas where job creation is hard to do. Sierra Trading Post is a good example of this. We have created 500 new jobs over the last 14 years in Cheyenne, WY. We have added 150 new jobs in Cody, WY. Remember this: this industry levels the playing field. This industry allows somebody with a bright idea and very little money to get in the game. This drives big business crazy.

Finally, this discussion is about a still-fledgling industry. Direct marketing, and especially selling over the Web, is still in its formative stages. Do not let people kid you. Selling over the Web is not close to maturing. It has a bright future, but perils abound.

Significant additional financial and governmental red tape and road blocks will dampen this entrepreneurial engine. I would not like to see this happen, and I do not believe you would, either.

So what do I recommend? My recommendations on this issue are two-fold. I believe the concept of nexus is paramount. If an entity has physical presence in a State, then I believe that entity needs to collect sales tax from that State.

Sierra Trading Post religiously adheres to that concept. I believe nexus should be strictly enforced and defined further, if necessary. This philosophy pre-dates the web and has worked well for years with the direct marketing industry.

Secondly, I believe that we as an industry need to quit playing shell games. Nexus is nexus. Setting up operations in separate companies, holding companies, et cetera, does not negate nexus. We need to be honest in this.

I know there is a significant rush towards tax simplification in an effort to tax Internet sales. There is a lot of pressure on this committee and this body to address these issues. Many governmental entities are clamoring for you to address this. This is all being done in the guise of fairness and the belief that there is a leakage of taxes.

I would urge you to be very cautious, however, before you rush into a tax program. As already mentioned in this discussion, in my opinion this is not about fairness or leakage, it is all about small business and job creation.

I am afraid that people will rush to grab the gold ring of Internet taxation, and when they grab it, discover the gold ring is not gold, but dust, because of the burden of implementing, managing, and collecting this tax revenue. This more burdened tax structure, I am afraid, will also result in a loss of jobs and entrepreneurial activity.

Thank you.

Senator THOMAS. Thank you very much.

[The prepared statement of Mr. Imig appears in the appendix.]

Senator THOMAS. Thank you, gentlemen.

We will have short questions, and perhaps short answers.

Mr. Noble, you mentioned a number of things. Would you just select what you think is the most significant problem in terms of implementing the proposal that is out here?

Mr. NOBLE. The most significant problem facing the States at this point?

Senator THOMAS. Well, in order to get your support to get done.

Mr. NOBLE. I think the largest challenge that is facing the States today is, obviously, demonstrating to you folks, to the Congress, that we can make this technological model work.

Senator THOMAS. I see.

Mr. NOBLE. I think it is critical for us to make that happen. I think we are very close to being able to demonstrate that. The certified service providers are out trying to market their wares.

Senator THOMAS. So you can overcome 7,200 different jurisdictions?

Mr. NOBLE. I think that is the idea: to basically utilize technology to overcome that. This is a transaction that is very, very similar to a credit card transaction. I guess I would say it is not rocket science. This is something that involves the use of databases and electronic technology to basically make this work.

Senator THOMAS. All right. Thank you.

Mr. Isaacson, you do some constitutional work. What is your impression as to the constitutionality of, for instance, the Enzi bill?

Mr. ISAACSON. One of the things that really concerns me, Mr. Chairman, is the tendency of State tax administrators and the proponents of the SSTP to trivialize the constitutional issues that are present here and to refer to the *Quill* case as a constitutional loophole.

In fact, when the Constitutional Convention was convened in 1787, the reason why it was convened was because the young Nation was being pushed into a depression because of the fact that States were imposing tax on commerce between themselves. It has been the Commerce Clause that created a common market on the North American continent 200 years before the Europeans did it with the EU.

The idea that we are going to disregard the standards of Federalism and the protections of interstate commerce that are associated with the Commerce Clause for the convenience of State tax administrators being able to impose tax collection obligations irrespective of borders, I think, runs directly contrary to the principles of Federalism and the principles of the Commerce Clause.

Senator THOMAS. I guess I do not quite understand. So are you supportive of doing something to collect State taxes on these interstate transactions?

Mr. ISAACSON. States have done a great number of things already to collect State taxes. For example, California, Kentucky, Maine all have lines on their State income tax returns. It is actually a very easy item to audit for States. Some States have been more aggressive than others on educating their citizens on that fact.

If you are going to engage in a much more substantial change in standards of Federalism, then what the Congress should really insist upon is high-bar reform, the kind of substantive reform that is not going to result in the complexities that exist in the current system.

That is what Congress' commission was intended to address, the Advisory Commission on Electronic Commerce. It was the advice of

the Advisory Commission that the Streamlined Sales Tax Project simply rejected.

Senator THOMAS. All right.

Mr. ISAACSON. Just to comment, for example, on the technology fix, because I think that relates to it. The Federal Reserve Bank has indicated that 45 percent of consumer transactions are still paid for by check.

Now, Mr. Noble suggested there is a technology fix. But for the consumer who gets a catalog and is paying by check, I do not understand how a certified service provider or software helps the consumer compute that tax obligation that they are going to have to a foreign jurisdiction. The issues of integration of software——

Senator THOMAS. What do you mean, to a foreign jurisdiction? The consumer is paying the tax in his own jurisdiction, is he not?

Mr. ISAACSON. The consumer is paying the tax in their own jurisdiction and has to compute that tax based upon the demands that are associated with 7,500 different jurisdictions.

Senator THOMAS. Yes. All right.

Mr. Rants, how do you deal with this jurisdictional issue? Just very briefly, please.

Mr. RANTS. Senator, I do not think that there is a problem. I truly believe there is a remedy to that with software. It is a database problem. If you are paying by check and you are living in Sioux City, IA, you know that you are currently paying 7 percent sales tax.

Remember, this is a tax on the consumer based on the tax rate in their jurisdiction. It is only the remote seller that we are asking to be the person to collect that tax.

Senator THOMAS. All right. Thank you.

Mr. Benham, I did not quite understand. What do you think is going to help you expand your business, by having this tax or not having it?

Mr. BENHAM. Well, two things will help it.

Senator THOMAS. What will?

Mr. BENHAM. By having the sales tax simplification.

Senator THOMAS. All right.

Mr. BENHAM. And by having us have the ability to have competing retail—let me give you a for example of what happens in our store, if I may, please. I will be brief. We have a customer come into our store. We have a substantial cosmetics business in our store. The customer sits down in a chair at our counter.

Our expert sales associate, who has been trained, applies makeup, writes down all the products, and the customer says, thank you very much, and actually will tell you they are going to order it on the Internet. I am losing business, my girls are losing commissions, and my city is losing the tax revenue. By having this legislation passed, that will stop that practice. It will help my in-store sales and it will help me expand my Internet sales.

Senator THOMAS. All right. Do you think the tax will keep people from buying it on the Internet?

Mr. BENHAM. I think the equality of tax will keep people buying it in my store, which is my primary interest.

Senator THOMAS. I understand that.

Your business is fairly unique, Mr. Imig. Do you think, if this were passed, it would change the way you do business?

Mr. IMIG. Yes, I do, Senator. I believe that we are close to a fairly level playing field right now because of the shipping charges that we have to charge as it is. The customer looks at their price of entry, so to speak, on buying something. The reality is, they look at shipping charges as a trade-off to sales tax. That is the reality of it. I am not kidding you when I say that.

In my opinion, some of the small business retailers should really be jumping on trying to support the Internet business, because in the long run there are not going to be a lot of small business retailers left if they are not selling unique product because they are competing against big chains.

Senator THOMAS. Thank you.

Senator Bingaman?

Senator BINGAMAN. Let me just indicate, my own view on this is that you can have small businesses that are local brick-and-mortar operations competing against great, big companies on the Internet, or you can have big businesses like the local Wal-Mart competing against small companies on the Internet. So I do not really think, Mr. Imig, your point is a valid one, that this is solely a question of little guys versus big guys.

As I see it, in my State, if I have a guy in a town in my State who is trying to run a bookstore and he is required to charge sales tax on every book he sells, why should Barnes & Noble, or Borders, or Amazon be able to sell that book without charging that same sales tax?

Why don't you tell me what your thought is on that? Why should we be giving those large retailers an advantage over the small retailer that is a brick-and-mortar operation?

Mr. IMIG. Well, it depends upon the size of your community. Probably a community of 30,000, 40,000 probably has a Barnes & Noble already and they are paying sales tax.

Senator BINGAMAN. Well, there are about three communities in my State that have a Barnes & Noble. The rest of my State does not have a Barnes & Noble. There are a lot of small businesses still in those communities that are trying to compete and sell their products.

Mr. IMIG. I cannot speak for them, but I can speak for us. If somebody bought $50 worth of product from us, they are also going to get charged a $10 shipping charge, which is more than the tax.

Senator BINGAMAN. But all you are saying there is, UPS may make out like a bandit, or FedEx, but the State is getting no revenue, the local community is getting no revenue, the local retailer is disadvantaged.

Mr. IMIG. That is the way the direct marketing business has been for 100 years. So when you start applying these type of taxes, it changes the dynamic of direct marketing.

Senator BINGAMAN. As I see it, the reality on the ground has changed. The direct marketing business is growing like crazy because of the Internet, primarily. For other reasons, too, perhaps, but primarily because of the Internet.

There are a lot of advantages. If I want to buy a book, there are a lot of advantages to trying to do it on the Internet. It is easier

to find what is available. It is easier to find the cheapest copy anywhere in the country.

So, there are a lot of reasons why I would still buy over the Internet instead of buying from my local bookstore. But I hate to add to that problem for the local retailer.

That seems to me what we have in place right now, is a situation where the local retailer, who is trying to keep his business open and pay his employees and be a member of the community, is at a substantial disadvantage.

I do not know. Maybe I am missing something in this analysis. But I really do not see that there is much of an argument for saying we should have one set of rules for people who are trying to operate in brick-and-mortar operations, and a different set of rules if you just operate on the Internet. It just does not make any sense.

I will stop with that, Mr. Chairman.

Senator THOMAS. Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

I would be interested in hearing the views of the members of this panel—and I will start with you, Mr. Isaacson—concerning the impact on small businesses. As chair of the Small Business Committee, this is obviously one of my concerns, because the Internet does afford small retailers the opportunity to do business and to expand their businesses.

Yet, there is no question there is a disproportionate impact on small retailers being able to, as Mr. Imig was mentioning, conform to the collection of this tax.

In fact, Ernst & Young conducted a study. They reported, for merchants selling in all 45 States having a sales tax, the cost of compliance for large retailers was 14 percent of the tax collected by the retailer. For small retailers, the cost of compliance was 87 percent of the tax collected.

Is there any way of leveling the playing field for this disparity and making it easier for small retailers? Do you see any way in which that can be accomplished?

Mr. ISAACSON. Senator Snowe, I think the problem for small retailers is serious. That study by Ernst & Young is scary, that it costs 87 percent of the amount of tax that is collected for the small retailer to be able to collect it.

As Mr. Imig has pointed out, the Internet has been a great opportunity for Main Street merchants like Mr. Benham to be able to access national and international markets.

Anything that would throw a wet blanket on that is a matter of great concern. Many small businesses, especially those in Maine, for example, that have entered the area of direct marketing do so in the gift field, that is, third-party transactions.

Senator Thomas was asking me about the problem that is associated with a purchaser computing their own tax. The Streamlined Sales Tax Project has destination-based sourcing.

That means if a grandmother in Lewiston, ME is sending product to her grandchildren located in four different States, that grandmother has to compute the tax in all of those four different States, even though she is the purchaser. For an individual to be confronting that, with the kind of niche markets that small businesses frequently inhabit, becomes a daunting task.

If the issue is one of level playing field, I think the real thing to look at is the fact that big bucks retailers are the ones who get enormous tax benefits, tax increment financing, subsidization of utilities and access roads. Those are the companies that are putting Main Street merchants out of business.

The Internet is the opportunity that is presented. Congress should be very cautious about imposing burdens on retailers that are disproportionately going to fall on small retailers.

Small retailers are not just companies that are selling $5 million a year, as Mr. Imig pointed out. If you are a small retailer in today's world, if you are competing against big bucks retailers, you are $40, $50, $60 million a year.

Senator SNOWE. Mr. Rants, would you care to comment?

Mr. RANTS. I would. Thank you, Senator. I think that the questions that small businesses probably are concerned about the most fall into two categories, one being the cost of compliance.

The goal of the Streamlined Sales Tax Project is to have the States begin to pick up that cost of compliance. That is a legitimate concern they have. But the concern that I hear from small businesses who, in Iowa, are on our Private Sector Advisory Council that we have, is the fear that they have that they are going to be the ones left holding the bag.

The brick-and-mortar merchant who is left to pay the increase in property taxes or other forms of taxation that continue, that still remain for a State or a local government to impose to fund our schools, to fund our police powers, to fund all the other things that we expect in our community, it is the merchants that are left at home that have to continue to pay that tax in some other form.

Sales tax is not the only form of taxation that we have. When local governments are not able to recoup, whether it be for Medicaid at the State level or education at the local level, those costs through their sales tax, they turn to other forms of taxation, like property taxes.

That all falls on the brick-and-mortar merchant who is now collecting more in taxes, or in some cases paying more in taxes on their own profits, while they see their sales being eroded to out-of-State merchants.

Senator SNOWE. I appreciate that.

Mr. Benham, you were talking about people coming into your store, looking at cosmetics, and then saying they are going to purchase on the Internet. Do they indicate that it is because they will be exempted from taxation? I mean, is that the most frequently heard comment?

Mr. BENHAM. Yes. We know that is the case, Senator. In some cases, people will actually—for example, we sell very nice things in our store. For example, on a St. John outfit, St. John Knits, customers will actually bring in a print-out from a website of a major out-of-State retailer with no nexus in Oklahoma.

They will come, they will try on the clothes, they will ask us to write down the vendor style number, and in some cases they are just very brazen about it. It is very destructive for morale in our store, and very destructive to our business.

Senator SNOWE. Mr. Imig?

Mr. IMIG. Yes, ma'am?

Senator SNOWE. You made reference to the impact on small businesses. Do you see any way of the U.S. Congress being able to establish a fair process that does not impose a disproportionate burden on small retailers?

Mr. IMIG. I would hope that we would be able to streamline it if we have to march to something like this. I would hope that we would be able to streamline it very substantially, almost to the point of one tax per State. We have 300,000 customers in New York and we have 350,000 customers in California.

Right now, we have trouble trying to keep track of the taxing authorities of Wyoming and Nevada, which obviously do not have a lot of taxing authorities. So it is a tough issue.

From my perspective, I think the Internet is really one of the great markets of small business creativity in the next 5 to 10 years, and I would really hate to see us put a damper on that creativity.

Senator SNOWE. I appreciate that.

Thank you, Mr. Chairman.

Senator THOMAS. Senator Crapo?

Senator CRAPO. Thank you, Mr. Chairman.

I note that we are going to have a vote soon, and we have another panel. I am going to save my questions for the next panel.

Senator THOMAS. All right.

Well, thank you, gentlemen. We appreciate it very much. We look forward to the next panel.

We will turn, now, to the issue of business activity taxes. The Supreme Court has stated that substantial nexus is required for the State to impose business activity taxes on an entity. However, the question of what constitutes a substantial nexus remains an open one.

Consequently, each State is free to interpret this as it sees fit. This has resulted in a rather haphazard and uncoordinated imposition of BAT by different jurisdictions, sometimes on the same income.

One of the questions we run into is, does the substantial nexus standard need to be further clarified, and, if so, what is the proper standard? My colleagues, Senator Crapo and Senator Schumer, have introduced a bill that would establish physical presence as the requirement of substantial nexus.

So we will now turn to that panel. While they are getting there, Senator Crapo, would you care to make a comment on the proposed legislation?

Senator CRAPO. Yes, Mr. Chairman. Thank you for holding this hearing. I had a lengthy statement, but I will forego that because of the shortness on time that we have here.

I do have a number of letters that I would like to make a part of the record, if that would be without objection.

Senator THOMAS. They will be made a part of the record.

Senator CRAPO. Thank you, Mr. Chairman.

[The letters appear in the appendix on p. 89.]

Senator CRAPO. I will just simply say, the bottom line here is that all income should be taxed, but it should be taxed only once. The issues we are addressing with this legislation are interstate commerce issues, which the Supreme Court and the Constitution rightly say are up to Congress to develop.

Senator Schumer and I want to ensure that the Federal Government, along with the State and local governments, retain the tools that they need to ensure that income is not sheltered and that it is appropriately taxed in the jurisdictions where it should be taxed.

At the same time, we want to assure that the same income is not double- or triple-taxed in jurisdictions where the nexus is not sufficient. By creating a uniform bright line test, which has already been upheld by the Supreme Court as appropriate for sales and use taxes and is consistent with international tax policy, we are attempting to achieve these important goals.

With that, I would like to get on with the witnesses.

Senator THOMAS. Very good. Thank you.

Mr. Douglas Lindholm, president and executive director of the Council on State Taxation; Dan Bucks, Director, Montana Department of Revenue; and Michael Mundaca, partner, Ernst & Young, International Tax Services.

Gentlemen, welcome. We will start with you, Mr. Lindholm. We are going to be pushed against a vote, so if you would try to consolidate your statements, we would appreciate it.

Mr. LINDHOLM. I will be as brief as possible. We do appreciate the effort.

STATEMENT OF DOUGLAS L. LINDHOLM, PRESIDENT AND EXECUTIVE DIRECTOR, COUNCIL ON STATE TAXATION, WASHINGTON, DC

Mr. LINDHOLM. As you indicated, I am Doug Lindholm. I am the president and executive director of the Council on State Taxation, also known as COST. We represent nearly 600 of the Nation's largest companies on State tax issues and on State tax policy matters.

I very much appreciate the opportunity to be here with you today to discuss this issue, and that is the appropriate extent of State jurisdiction of tax, also known as nexus.

In my testimony today I want to touch on three questions. The first question is, why does the issue of business activity tax nexus warrant Congressional action? The second question: why is physical presence the appropriate standard for business activity tax nexus? Finally, what impact would a physical presence standard have on State revenues?

Question one. Why do we feel that Congress needs to act on BAT nexus? The most fundamental determination that a business has to make any time they assess a business activity tax is whether that business is actually subject to that tax at all. The standard for making that determination is also, not coincidentally, the single greatest unanswered question in the State tax arena today.

We have numerous times tried to get this issue before the U.S. Supreme Court, but they have not considered the issue in the context of business activity taxes, and results from State courts are, predictably, mixed.

We do have some ancillary guidance, however. In the *Bellas Hess* case in 1967, and the *Quill* case in 1992, the Supreme Court noted that physical presence is required for nexus before a State can impose a sales tax collection duty.

They did not address the issue of business activity tax nexus, but in that case they specifically invited Congress to legislate on the

nexus question, and they specifically indicated that they felt that Congress was the appropriate body to resolve this issue.

Now, I realize that you and your colleagues have been hearing a great deal from the States about how unnecessary Congressional action is on this issue. I think that is entirely appropriate. There is a natural tension between States' authority to tax and the authority of Congress to regulate interstate commerce.

But please recognize that, absent Congressional action, States have every incentive to become more aggressive in asserting economic nexus over out-of-State businesses. I cannot say I blame them. I mean, it is a great way to export their tax burden.

However, they do not have a similar incentive to assess the impact of their aggressiveness on the free flow of interstate commerce. That is clearly Congress' purview, and that is why we are here before you today.

My written testimony illustrates a number of reasons why the current uncertainty in this area is creating real burdens for businesses and why we feel that Congress is the ultimate authority, under the Commerce Clause, to address and resolve this issue.

Question two. Why is physical presence the appropriate standard? That question, we feel, should be guided by one fundamental principle, and that is that a government has the right to impose burdens only on businesses that receive meaningful benefits or protection from that government.

The physical presence standard is a clear, predictable, and enforceable standard, and it is based on where companies actually earn their income, in other words, where they employ their labor and their capital. It is the standard that most companies use today.

I would like to read to you some words of a former executive director of the Multistate Tax Commission, Gene Corrigan, who is arguing for a compromise on this issue: "The States need to face the reality that most of them are generally incapable of enforcing the doing business—that is the economic presence—standard anyway. In almost all cases, they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-State businesses, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general, and with mixed success at best."

The States have had over 40 years, ever since the formation and adoption of the Willis Commission and their report, to try to formulate a workable nexus standard, and they have been unable to do so. Clearly, I think it is time for Congress to step forward and address this issue.

Finally, let me address the impact on State revenues of a physical presence test. We, several months ago, retained Ernst & Young to prepare an independent estimate of the fiscal impact of the House bill, H.R. 1956. The Senate bill, S. 2721, is identical.

According to that study, in the first year, the estimated revenue loss for all States is $434 million. Now, that revenue loss is 0.8 percent of the total State and local business activity taxes covered by the legislation. If you compare that to all State and local taxes paid by business in 2005, the revenue loss is less than one-tenth of 1 percent.

Now, even the CBO estimate of $1 billion in the first year is significantly less than 1 percent of total State tax collections. I realize that you have gotten some conflicting revenue estimates here.

One of the things the E&Y study that we have put in the record does is it explains the key differences between those studies. I would encourage this committee to specifically evaluate those differences for both reasonableness and objectivity when you compare the various fiscal estimates.

To conclude, we are very interested in working with this committee and other interested parties to develop a bright line physical presence nexus standard. Again, I appreciate the opportunity to be here and would be happy to answer questions.

Senator THOMAS. Thank you very much.

[The prepared statement of Mr. Lindholm appears in the appendix.]

Senator THOMAS. Mr. Bucks?

STATEMENT OF DAN BUCKS, DIRECTOR, MONTANA DEPARTMENT OF REVENUE, HELENA, MT

Mr. BUCKS. Thank you, Mr. Chairman and members of the committee. I appreciate the opportunity to appear before the subcommittee on the issue of tax jurisdiction in the new economy.

I will address the topic generally, but will focus on S. 2721, the so-called Business Activity Tax Simplification Act, because the legislation is actively before the committee.

I am Dan Bucks, Director of Revenue for the State of Montana. I appear today at the request of the Ranking Member of the full committee, Senator Baucus.

Montana is proud of the work that Senator Baucus has done, in cooperation with the committee chair, Senator Grassley, and the entire committee, in curbing abusive tax shelters. We thank this committee for its leadership on this issue.

States are adding their own enforcement weight to the Federal effort to clean up the abusive tax shelter mess, and this is one example of the mutually beneficial cooperation that can occur between the Federal and State governments to improve the equity and integrity of our shared income tax system.

I appear in support of that kind of cooperation between the States and the Federal Government, and in opposition to S. 2721 and the outmoded concepts underlying the bill.

S. 2721 is the antithesis of cooperation, because it would render useless State business taxes and destroy their equity and integrity. My arguments in opposition to this bill are consistent with the policy positions of the National Governors Association, the Federation of Tax Administrators, and the Multistate Tax Commission.

States have long experience and knowledge to offer the Federal Government in understanding how to make income taxes work in the new economy. Because the U.S. is the world's first modern common market, States have pioneered, over nearly a century, the principles that make income taxes equitable and effective in an open trade environment.

States have long applied economic presence nexus standards to ensure that all who compete in their State's marketplace pay equal taxes. To use one example, this standard has been critical to efforts

of many States to prevent abusive income shifting by corporations using intellectual property holding companies to improperly avoid State taxes. The Federal Government now faces this very same problem. States are solving this problem and can help the Federal Government solve it as well.

So we urge Congress not to engage in conflict with the States through preemption legislation such as S. 2721. Instead, we urge you to recognize the value of State experience as laboratories of democracy and in shaping tax systems that work well in the new economy.

More specifically, I ask you to reject S. 2721, for several reasons. The bill will legalize tax shelters that States consider abusive and would disallow under current law. The tax shelters blessed by this bill will allow many large corporations to reduce their State tax liabilities to virtually zero.

Aiding and abetting improper corporate tax planning through this bill is inconsistent with this committee's efforts to reduce tax sheltering at the Federal level.

As estimated by the Congressional Budget Office, the bill constitutes a huge unfunded mandate on the States which, if enacted, would constitute the largest such mandate ever imposed by Congress on the States.

The CBO says that the bill will place at risk up to 75 percent of the State business tax base. The revenue losses imposed by the bill will shift the burden away from large, out-of-State companies to smaller local businesses.

The bill distorts investment decisions and harms the economic development of the States, especially in more rural States whose local economies depend on local businesses that will bear the brunt of the tax shift imposed by this bill.

Physical presence standards of nexus for tax purposes act as an investment barrier that discourages companies from investing in States where they market their goods and services and from which they earn their profits. The bill simply undermines local economies and local communities.

The bill does significant harm to our Federal system by undermining State sovereignty and overturns established constitutional precedent on the jurisdiction of States to impose tax on entities doing business in the State.

The States have developed a straightforward, bright line nexus standard for business activity taxes that is consistent with existing constitutional standards and is in tune with the 21st century economy.

Unfortunately, the business community has summarily rejected that standard and continues, instead, to insist on an outdated physical presence nexus standard that promotes inappropriate State tax sheltering.

In short, this bill creates the world's largest tax shelters available to the world's largest corporations, and this is simply wrong.

Senator THOMAS. Thank you.

[The prepared statement of Mr. Bucks appears in the appendix.]

Senator THOMAS. Mr. Mundaca?

STATEMENT OF MICHAEL MUNDACA, PARTNER, ERNST & YOUNG, LLP, NATIONAL TAX DEPARTMENT, INTERNATIONAL TAX SERVICES, WASHINGTON, DC

Mr. MUNDACA. Thank you. Good morning. I am Michael Mundaca. I am in the International Tax Services group of the accounting firm of Ernst & Young here in Washington, DC. I would like to thank you, Mr. Chairman, for the opportunity to testify, and Senator Crapo as well.

Although many of our clients are interested in the issue of tax jurisdiction, I am not testifying on behalf of any clients or on behalf of Ernst & Young, and the views expressed here are my own.

What I would like to discuss are the current U.S. Federal income tax jurisdictional rules contained in the U.S. income tax treaty network, as well as the application and development of those rules with respect to transactions in the new economy.

I hope this might provide some insight for the discussion of the income tax jurisdictional rules that should apply to the U.S. States. In addition, I would like to discuss some possible international effects of expanded State income tax jurisdiction.

Under our tax treaties, the limits of tax jurisdiction to tax business income are set out in the permanent establishment, or PE, rules. Permanent establishment articles are found in every one of the more than 60 U.S. income tax treaties, as well as in the thousands of bilateral income tax treaties in force around the globe.

I will describe the OECD model PE provision, as that provision is the most widely used in the world and differs only in very minor respects, if at all, from the provisions of U.S. income tax treaties.

Under the OECD model PE provision, the business profits of a non-resident enterprise are taxable only if the enterprise has a PE. The OECD defines a PE, in general, as a fixed place of business, a physical presence, such as an office or a factory.

The OECD model also includes a list of so-called preparatory or auxiliary activities that will not constitute a PE, even if conducted through a fixed place of business.

Obviously, much has changed in the global economy and in business practices since the development of the PE concept over 80 years ago, and some have questioned whether a jurisdictional concept so reliant on physical presence makes sense in an economy now so driven by services and intangibles.

It was just these sorts of questions that prompted the U.S. and the OECD, in 1996, to consider the application of the current rules to new business models. After years of study, discussion, and consultation with the business community and others, the OECD was able, in 2000, to release consensus changes to the official interpretation of the PE rules, as applied to certain electronic commerce business transactions. Those changes maintain the rule's firm reliance on physical presence.

Strong arguments remain for keeping the PE physical presence, even in the new global economy. An almost universal global consensus has been achieved regarding use of the PE standard to determine income tax jurisdiction, and this has created much-needed uniformity, predictability, and certainty from multinational taxpayers and others, including the increasing number of smaller businesses that have gone global.

Now I would like to turn, briefly, to the current interaction of the Federal income tax jurisdictional rules I have just described with State income tax jurisdictional rules.

By their terms, U.S. income tax treaties do not, in general, apply to State taxes, and therefore it is possible that a foreign corporation may be exempt from income taxation on the Federal level under a treaty, but may nevertheless be subject to State income taxation.

The limits on State taxing powers has been the subject of much litigation, and the Supreme Court has spoken regarding the international interactions as recently as 1994.

In the *Barclay's Bank* case, the U.S. Supreme Court held that California's worldwide apportionment system was constitutional, even when applied to foreign corporations, and even though the system was not in accord with our treaty obligations and could result in double taxation.

Interestingly, however, by the time the *Barclay's* decision was handed down, California had allowed taxpayers an election out of the worldwide system. That change was made in response to threats by foreign corporations to take their business elsewhere, as well as by the threat of Federal legislation, which was itself prompted by complaints from foreign governments.

I raise the *Barclay's* case because I think it demonstrates not only the limited effect of tax treaties on State tax authority, but also the potential reaction of foreign corporations and governments to expansive State taxation.

Coupled with the already increasing pressure on the PE standard from countries that view the rules as inadequate, assertions of expansive tax jurisdiction by the U.S. States could prompt not only protests or retaliation by foreign governments and corporations, but also encourage foreign countries and international organizations to reevaluate the PE standard.

We have already seen in the European Union, in the context of value added taxes, the EU placed tax collection obligations on corporations that have customers, but no physical presence, in the EU.

To conclude, our experiences in the international tax area, using the well-established PE concept, have demonstrated that a clear physical presence standard has created uniformity, predictability, and certainty. It has helped mitigate double taxation and prevent tax jurisdictional disputes.

In addition, it has alleviated the administrative burden that would be imposed if taxpayers were forced to file and pay income tax in every jurisdiction in which they have customers or other sources of business income. Multistate taxpayers, likewise, can benefit from a similarly clear consensus standard.

There is no argument that our economy has changed and our tax rules need to reflect those changes. However, there should be no argument that we should strive for uniformity.

Senator THOMAS. I am sorry to interrupt you, but we have a vote pending and I know Senator Crapo has a couple of questions.

Mr. MUNDACA. Sure.

Senator THOMAS. So, thank you very much.

Mr. MUNDACA. Thanks.

[The prepared statement of Mr. Mundaca appears in the appendix.]

Senator THOMAS. Senator Crapo?

Senator CRAPO. Thank you very much. I think you were pretty much wrapping up anyway there, Mr. Mundaca, so I appreciate that. I apologize to the entire panel. We probably are not going to have more than just 5 minutes or so for questions here because of the vote that has been called, so I would ask you to keep your responses as brief as possible.

But let me just ask, generally to the entire panel, is there any disagreement on the panel that, whatever our system of income taxation should be, that we should strive to achieve one in which we do not have different jurisdictions taxing this same income? Is there any disagreement with that?

Mr. MUNDACA. None from me, Senator.

Mr. LINDHOLM. No.

Senator CRAPO. I will take that as no from the entire panel.

Mr. Bucks, you indicated that if this legislation were enacted into law, that many corporations could reduce their State liability to zero, I assume in certain States.

Now, I want to clarify, though. That does not mean that those corporations would reduce their income tax liability to zero, but that they would not be paying tax on that same income in multiple jurisdictions. Is that not correct?

Mr. BUCKS. Senator, I would respectfully disagree. In fact, the Congressional Research Service found, in its report on the issue of a physical presence nexus standard, that in many instances corporations could in fact produce large quantities of nowhere income, meaning that it is not taxed anywhere.

That is, in fact, the result, particularly in the case of the use of intellectual property holding companies, where companies virtually have eliminated their taxes to zero. The Federal Government is facing the same problem now with regard to offshore intellectual property holding companies.

In fact, through the physical presence standard, companies can reduce their combined State corporate income tax liability to virtually zero.

Senator CRAPO. Mr. Lindholm, do you have a comment on that?

Mr. LINDHOLM. I certainly do. I think Mr. Bucks, when he mentions State tax liabilities, means income tax liability. That clearly will not impact the amount of taxes companies are paying. Businesses are paying sales tax, payroll tax, excise taxes, franchise taxes, et cetera.

Even on the income tax issue, I respectfully disagree with Dan. To think that a company will be able to reduce their income tax liability to zero is absolutely ludicrous. Even the estimates from the States—and we think they are somewhat exaggerated—only range from zero to 30 percent.

Senator CRAPO. Mr. Mundaca, do you have an opinion on that question?

Mr. MUNDACA. Yes. On the international side, we do see some corporations that are able to use tax planning to drive their income tax liability down. But I do not see it so much as a jurisdictional issue.

There are transfer pricing concerns, there are concerns with information exchange. But I think the jurisdictional rules have served us well and have mitigated double taxation, and have not created no taxation.

Senator CRAPO. Again, I apologize that we cannot spend the time to explore some of these in this hearing to the depth that we need to. I am probably going to have to just get into one more area, then wrap it up. But we certainly will continue to explore the issues that have been raised by the witnesses.

Mr. Lindholm, the next area I wanted to get into was the area of revenue estimates, and I would welcome the input of others on the panel on this.

The NGA has estimated the revenue lost to the States from this legislation to be around $6 billion a year. The CBO has put that cost at between $1 and $3 billion a year. Your own organization, COST, has estimated that it will be even less, down around $300 million a year.

Can you explain why we have such significantly different estimates?

Mr. LINDHOLM. I certainly can. The NGA estimate was done on an earlier version of the bill and it takes into account some items and issues that are clearly not covered by the latest version. They were not intended to be covered by the earlier version, but there was some ambiguity there.

The NGA also, if you look at that study, it is reflective of the fact that many of the States that responded to the survey disagreed on the bill's provisions. For example, one State thought that it might impact their ability to even impose combined reporting. That is obviously not the case.

The CBO estimate is much closer to our estimate, but even then we disagree with some of the methodologies and assumptions of the CBO. For example, some of the restructuring that Mr. Bucks indicated may occur happens if a company then uses an independent contractor in a State. The CBO estimate does not reflect the fact that those independent contractors that are still operating in the State would see a resulting increase in income as well.

There are some other issues that highlight the differences. They are all very well spelled out in the E&Y study. I encourage, in the interest of time, you to review that.

Senator CRAPO. Thank you.

Mr. Bucks, do you want to make a comment on that?

Mr. BUCKS. Yes, Senator. Just very simply, the CBO estimates indicate that this bill, if enacted, would be the largest unfunded mandate ever imposed on the States. Our perspective, the State tax officials' perspective, is very similar to CBO's: the impact is large and it will grow over time as companies restructure.

The difference is that when the States estimate their revenue impact, they uniquely have access to the actual tax returns of companies. That is how we estimated it in Montana. We have to advise, as officials, our legislatures and Governors accurately because of the balanced budget requirements of the States.

We stand behind our estimates because they are the only estimates that are based upon reviewing all of the major tax returns that we received in the State that would be implicated by this bill,

and we think the CBO perspective generally confirms ours, although they did not have access to the tax returns.

Mr. LINDHOLM. If I may, Senator.

Senator CRAPO. Yes. Briefly.

Mr. LINDHOLM. E&Y had access to the same results, the survey results, that the States provided to the NGA to formulate that study.

Mr. BUCKS. Senator, if I could just comment. Survey results are different from the actual tax returns and the actual tax records of the companies. Those are different things. The E&Y study may have drawn from summary results, but not from the actual tax returns.

Senator CRAPO. Well, thank you. I am looking at the clock here. The time for the vote that just started is probably expiring on the floor of the Senate right about now, so I am going to have to wrap up this hearing. I have a whole folder full of materials and questions I wanted to get into with this panel.

But let me just say that one of the reasons that the other Senators had to leave was because of the vote as well. I am quite confident that you will receive some written questions, not only from me, but some of the other Senators who were not able to be here to ask their questions.

We will continue through that process, as well as through just the general legislative process, to explore the issues that you have all raised as we pursue this legislation.

I do apologize that we did not have time to get into these kinds of issues with you in the question and answer period in this panel, but nonetheless, your testimony is appreciated, well received, and will be thoroughly reviewed and vetted.

With that, I guess I have been delegated the authority to conclude this hearing. This hearing is adjourned. Thank you.

[Whereupon, at 12:05 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Testimony of the National Retail Federation

By Robert Benham
President & CEO, Balliet's, L.L.C.

Before the
United States Senate
Subcommittee on International Trade
Senate Finance Committee
Hearing Regarding: "How Much Should Borders Matter?: Tax Jurisdiction and the New Economy,"
In Support of S. 2152, the
Sales Tax Fairness and Simplification Act
Room 215 Dirksen Senate Office Building
July 25, 2006
10:30 A.M.

Good morning Subcommittee Chairman Thomas, Ranking Member Bingaman and members of the Committee. My name is Robert Benham. I am the owner/proprietor of Balliet's, L.L.C., an independent full-line women's specialty shop operating a single store in Oklahoma City, Oklahoma. I am here today on behalf of my business and other small businesses like mine, as well as on behalf of the National Retail Federation (NRF) as a representative of the NRF Board of Directors that I have served on for 25 years. I am here to comment as a small business owner and to share my unified position with NRF's in support of S. 2152, the Sales Tax Fairness and Simplification Act, introduced this session by Senator Michael Enzi (R-WY), and to urge action by Congress in 2006 to authorize the states to require sales tax collection by all channels of sellers – big, small, brick and mortar, catalogue and online.

Retailer Background:

As a lifelong retailer, I purchased Balliet's in 1991, after first holding corporate management positions in three major department store chains. Balliet's is this year celebrating its 70th year in business, opening its doors first in 1936. I am proud to afford to employ 32 people, and provide them with health care and dental benefits, life insurance and a 401K saving and investment plan. These workers are like family to me; these benefits are necessary to hire and retain quality employees.

Likewise, the committee should know that today I also speak as a member of the Board of Directors of the National Retail Federation, the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet, independent stores, chain restaurants, drug stores and grocery stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees - about one in five American workers - and 2005 sales of $4.4 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

As a member of the NRF Board, I voted with the majority of our Board back in January 2000 to adopt a policy to support the streamlined sales tax initiative in the states, and today urge you to pass S. 2152, federal legislation to transition this voluntary, cooperative state venture into a nationwide sales and use tax collection system, mandatory for all sellers.

History of Sales Tax Fairness: The Retail Perspective.

According to the rulings in two relevant United States Supreme Court decisions, *Bellas Hess* and *Quill*, the court ruled that state and local sales tax systems were complicated and placed an undue burden on interstate commerce. Because of this burden, remote, out-of-state sellers have been excused from collection of sales or use tax on sales made to remote buyers except in instances where the seller has nexus within the state of the buyer. The advent of the

Internet and growth of e-commerce retail sales established a situation where traditional "main street" sellers, with no e-commerce or remote sales activity, were both losing sales to competitors on the Internet, while also suffering a non-negotiable price disadvantage of an average of 6% (the average state sales tax rate) for selling the same goods. Considering that most retailer profit margins are on the scale of 3-4%, a non-negotiable price disadvantage of 6% on top of the cost of the goods being sold is clearly a significant discrimination against main street sellers. "Non-negotiable price" -- the sales tax rate mandated for collection by retail on taxable items at storefront -- is a relevant distinction, as the shipping, handling and related delivery costs to a remote seller with no nexus in a state are ALL negotiable fees for completing a transaction with a remote buyer.

Small retailers like me readily agree that we benefit from and use services provided by state and local government, and thus we should be obligated to help support those services through collection of state and local sales taxes. But it is also true that services provided for by state and local government such as roads, fire and police are used every day by out-of-state sellers to facilitate the delivery and in-route protection of merchandise to in-state buyers. Why then should some collect and some not? The answer is there should be no distinction, and Congress is specifically empowered to take action under its Commerce Clause authority to eliminate this marketplace barrier.

Why Do Small Retailers Care about S. 2152?

NRF participation in the development of streamlined sales tax agreement (or "SSTA") among the states and our active involvement in the drafting of S. 2152 is based on many justifications, and I want to highlight four in particular:

1) **Sales tax is here to stay.** Of the tax revenue sources relied upon in states – property, income and/or sales – a consumption tax such as the sales tax has been found in numerous polls and public opinion surveys to be the least offensive to taxpayers, as taxpayers can "choose" to pay the tax based on how much they consume;
2) **Compensation for Retailer Costs**: Pre-SSTA, state and local sales tax systems were complicated and costly for retailers to administer. Seventeen (17) states today pay their in-state retailers a nominal fee for the cost of sales tax collection, and this number of states is dwindling. Today, the state Governing Board of the SSTA continues to work toward certification of tax software that will be available to me as a small retailer, for free. Likewise, S. 2152 ensures that the costs of collection are greatly reduced, and where costs still exist, retailers will be compensated for that cost – both nexus and non-nexus sellers (see Section 6(a)(14));
3) **Small Business Exception:** Pre-SSTA, small retailers looking to grow their business outside their state had no certainty in tax planning. 7,600 different state and local taxing jurisdictions have varying rates, varying definitions and varying rules, often forcing retailers to guess about taxability. S. 2152 provided a small business exception that exempts

small sellers from the obligation to collect use tax. A small seller is one who sells less than $5 million in gross remote annual sales – that is $5 million outside their home state. Balliet's today is selling approximately $350,000 in goods outside of Oklahoma, amounting to about 5% of our total annual sales. Remote sales are an important part of our overall business strategy; we are a player in remote commerce, and I expect growth in this new channel to continue. As long as retailers are compensated for the cost of collection, as a small retailer, I see no reason for a small business exception – but I understand the politics which supports having an exception, at least at the beginning of the new system (see Section 4(d));

4) **Retailers Can Outsource Sales Tax Collection:** Under the SSTA, I can opt to have all my sales and use tax collected for me by a certified service provider (CSP), who will essentially remove me from the hassle, headache and responsibility of collection. Under this arrangement, the CSP as my collection agent will receive the compensation for collection of my sales and use tax from the states. (see Section 6(a)(4) and (14)).

It is also worth noting that S. 2152 provides other administrative simplifications that will greatly reduce collection burdens on me and other retailers – both big and small – such as a uniform sourcing rule (tax sourced to the destination of the buyer (Section 6(a)(3)); and a hold-harmless provision for good faith errors in collection (Section 6(a)(12)) to name but two more of 19 guarantees in the federal bill. S. 2152 establishes a road map for retailers to know what is taxable,

and at what rate – thus providing retailers with certainty in administration, while preserving the sovereign rights of states on political issues of taxability

Why S. 2152 Should Be Passed by the Congress:

(1) All Sellers Should be Compensated for the Costs of Collection:

Sales tax is a consumption tax. Customers that live in a state with sales and use taxes are individually responsible for payment of that tax to their home state. Legally, the in-state merchant collects the sales tax for the customer; typically, the out-of-state merchant without nexus to the buyer's state does not collect use tax for the customer. NRF believes that the appropriate place to collect a consumption tax – owed by customers – is at the selling site. NRF's interest, supported by the NRF Board as far back as January 2000, is in ensuring that the cost of collection for retailers be eliminated altogether, or minimized, and that the obligation to collect must apply equitably across all channels of sale. Likewise, for remote sellers that currently have no legal obligation to collect tax for their remote buyers, the remote seller's costs of collection should be paid for by the states. Senator Enzi's S. 2152 addresses this along with eighteen (18) other minimum simplifications that the states must adopt in order to be granted the authority to mandate collection of their use tax, and the SSTA bill also represents the necessary first step for equal collection responsibility for all sellers.

***(2) Congress Should Legislate, So Business Does not have to Litigate*:**

Small retailers need Congress to act, because only through passage of S. 2152

will small retailers get the advantages – and protections – of a mandatory collection system. After so many years into the streamlining of state sales tax systems, some states may assert that they have overcome the *Quill* restriction on their right to collect from out-of-state sellers. After investing years in supporting the effort of the streamlined process, retailers deserve the CERTAINTY and RULES that only an Act of Congress can provide to ensure a free flow of goods and fair tax collection across state lines.

(3) State Borders Should Not Matter for Sales and Use Tax Collection:

If S.2152 becomes law, states still decide what they tax and at what rate, but definitions are uniform and complicated rules and procedures are eliminated. For small retailers like me, I can then grow my business with certainty about the limited rules that vary among the states, I can choose to completely outsource my tax collection responsibilities, or I can finally get reimbursed for my costs of collection. States and business both win.

Conclusion.

As a small retailer and member of the National Retail Federation Board of Directors, I support S. 2152, and urge this subcommittee and the full Senate Finance Committee to pass this important business legislation in 2006. As retail assumes that the sales tax is both a significant, viable and the least offensive source of state and local government revenue, the administrative rules for sales and use tax collectors should be the same. The most feasible collector of this

consumption tax is the retailer, who with the help of modern technology, will now know with certainty what is taxed, and at what rate, regardless of which venue is used to complete the sale. Likewise, retailers believe the numerous benefits of S. 2152 can better be provided by a uniform legislative solution rather than the narrow interpretation of some courts. Small retailers need legislative certainty and the same set of tax collection rules across state lines if we hope to have a chance to compete with both big and small, catalogue and online sellers.

Mr. Chairman, I appreciate the invitation to come and address you and the committee members on the merits of S. 2152, and to specifically endorse action by Congress to modernize state sales tax systems.

Thank you for your kind attention.

Response to a Question for the Record
Mr. Robert Benham
July 25, 2006

From Senator Hatch:

Question: Mr. Benham, what do you say about Mr. Isaacson's statements that the Streamlined Sales and Use Tax Agreement has failed to establish uniformity of definitions, to reduce the burdens of tax collection, and that the tax compliance software is unproven?

Answer: In response to the inquiry of Senator Hatch regarding Mr. Isaacson's statements at the Senate Finance Committee hearing on Tuesday, July 25, 2006, clearly the Streamlined Sales and Use Tax Agreement establishes uniformity of definitions and relieves the burdens of tax collection on the retailer. We have been working through the streamlining and simplification process for six years, and have achieved clarity.

The software for tax compliance for retailers is near completion and will be certified by the governing board of each state. The process will provide certainty of compliance for retailers and consumers and be no more complex than collecting and remitting current state and local sales taxes.

This is a sales tax software program, not rocket science.

I appreciate that Mr. Isaacson represents a business segment that would like to retain an unfair competitive advantage, but I strongly disagree with his representations.

STATEMENT OF

DAN R. BUCKS
DIRECTOR, MONTANA DEPARTMENT OF REVENUE

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

HOW MUCH SHOULD BORDERS MATTER? TAX JURISDICTION IN THE NEW ECONOMY
S. 2721 – BUSINESS ACTIVITY TAX SIMPLIFICATION ACT

July 25, 2006

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to appear before the Subcommittee on the issue of "How Much Should Borders Matter? Tax Jurisdiction in the New Economy." I will address this issue generally, but focus my remarks on S. 2721, the Business Activity Tax Simplification Act since that it is the piece of legislation actively before the Committee.

I am Dan Bucks, Director of Revenue for the State of Montana. I am appearing here today at the request of the ranking member of the full Committee, Senator Baucus. I appear in support of cooperation between the states and the federal government in developing tax policies that fit with the new economy and in opposition to S. 2721 and the concepts underlying that bill. The arguments I am making today in opposition to S. 2721 are consistent with policy positions adopted by the National Governors Association as well as the Federation of Tax Administrators and the Multistate Tax Commission, two organizations comprised of state tax administrators from across the country.

Overview

There are strong reasons for the federal government and the states to engage in cooperation instead of conflict. The full Finance Committee has played a key leadership role in curbing abusive tax shelters and insisting that transactions reported for tax purposes reflect economic substance. Because state income taxes are linked to the federal tax, states benefit from and appreciate greatly the committee's work in restoring greater integrity to the income tax system. In turn, a growing number of states have added their own enforcement efforts—supplementing federal resources--to help clean up the abusive tax shelter mess.

This Subcommittee and the full Finance Committee have contributed to the development of a more open world economy. The evolution of the world trading system creates new challenges for the equitable and effective operation of tax systems. States have much to offer the federal government in understanding how to make income taxes work in the global economy. Because the U.S. Constitution established the world's first modern common market, states have dealt with these issues for nearly a century. Using the same principle that taxes should reflect economic substance, not taxpayer choice, states have forged income tax practices to ensure that business income is fully reported in reasonable relationship to where it is earned. Key elements in ensuring the full and proper accountability of income include economic presence for jurisdictional purposes and dividing income among states in proportion to actual business activity. These practices pioneered by the states—and once summarily rejected by international tax authorities--are now getting fresh attention by those same authorities. The federal government is now dealing with the improper shifting of income internationally through the use of offshore intellectual property holding companies. Many states are solving the same problem domestically by enforcing economic presence jurisdictional standards. We urge Congress not to engage in conflict with the states through preemption, such as is represented by S. 2721—a bill that is the antithesis of cooperation. We urge you to reject that bill and the outmoded physical presence concepts on which it is based. Instead we urge the federal government to engage in cooperative efforts with the states to learn from our respective experiences and shape tax practices based on economic substance and the reality of business operations in the world economy.

More specifically, I ask you to oppose S. 2721 for several reasons:

1. The bill will legalize tax shelters that states consider abusive and would disallow under current law. Tax shelters blessed by this bill will allow many multistate and multinational corporations to reduce their state tax liabilities to virtually zero. Aiding and abetting inappropriate corporate tax planning in this manner runs counter to the actions this Committee has taken to reduce tax sheltering at the federal level.

2. The bill constitutes a huge and unfair unfunded mandate on the states, which if enacted, would constitute the largest unfunded by Congress on the states.. The Congressional Budget Office estimates (conservatively, in my mind) that the tax sheltering allowed by the bill will reduce state revenues by $3 billion per year in 2011 and place at risk even larger sums running up to 75% of the business income tax base of the states. The revenue losses imposed by the bill will shift the tax burden away from large, multijurisdictional enterprises to smaller, local businesses.

3. The bill distorts investment decisions and harms the economic development of the states—especially more rural states whose local economies are dependent on the smaller, local businesses that will bear the brunt of the tax shift imposed by this bill. Physical presence standards of nexus for tax purposes act as a trade barrier that create a disincentive for companies to invest in the states where they market their goods and services and from which they earn profits. The bill undermines local communities by harming existing small businesses and discouraging new investment by enterprises committed to participating directly in the life of those communities.

4. The bill does significant harm to our federal system and overturns established constitutional precedent on the jurisdiction of states to impose tax on entities doing business in the state.

5. The manner in which P.L. 86-272 is expanded in the bill is without justification and runs contrary to all efforts to establish an effective and equitable state tax system in the 21st century.

6. The bill protects large businesses at the expense of small ones and favors out of state businesses over in-state taxpayers.

7. The states have developed a straightforward bright line nexus standard for business activity taxes that is consistent with existing constitutional standards and is in tune with the 21st Century economy. Unfortunately, that standard has been summarily been rejected by the business community that continues instead to insist on an outdated physical presence nexus standard that promotes inappropriate state tax sheltering.

I. S. 2721 legalizes abusive tax shelters at the state level and runs counter to the efforts of the Finance Committee to reduce tax sheltering at the federal level.

By expanding the scope of P.L. 86-272 (both in terms of the types of state business activity taxes covered and the types of activities in which an entity may engage without being considered to have a taxable presence in the state) and by establishing a physical presence nexus standard in federal law (along with all the attendant 'carve-outs' in the bill),[1] S. 2721 creates a virtual road map that will allow multistate and multinational corporations to structure their operations and to shelter various sources of income so as to reduce significantly or eliminate their state tax liability.[2] There are an almost infinite number of ways in which the bill could be used to avoid state business activity taxes, some of which are discussed below. Simply put, however, an entity can avoid state business activity taxes under the bill by locating its physical assets (property and payroll) in low-tax or no-tax jurisdictions and then limiting its activities in market states only to those activities shielded by P.L. 86-272 or conducting its operations in the market state through third parties or other remote means. Further S 2721 would encourage businesses to reorganize holding companies, management companies, etc. in low-tax or no-tax states and shift income from the states in which the incomes is earned.

The result of such sheltering is obvious:

(a) An appropriately structured operation can avoid business activity tax liability and still exploit the marketplace in any given state;

(b) In-state entities subject to state taxes face an unfair competitive disadvantage;

(c) The state tax base is seriously eroded;

(d) Business income and operations are not subjected to tax where the income is earned; and

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[1] Other features of the bill such as the ability to use contractors in a state without their activities being attributed to an entity for purposes of determining nexus and the classification of software licenses in the bill also create sheltering opportunities.

[2] "Tax sheltering," for state business activity tax purposes, means that income is not being fully reported to each state in a manner that "fairly represents" the business activity actually being conducted by the enterprise in each state in proportion to the property it uses, the people it employs or the sales it makes in each state. "Fairly represents" is a policy standard established in the Uniform Division of Income for Tax Purposes Act (UDITPA), as proposed by the American Bar Association.

(e) (e) The state business activity tax falls unevenly across similar types of businesses, depending solely on whether they have taken advantage of the sheltering opportunities afforded by the bill.

A Simple Example. One of the more common sheltering schemes is the use of an intangible holding company to shift income of retailers with many stores in a state to a low-or-no-tax state. The retailer's trademarks are moved to a holding company established in a low-or-no-tax state, and the affiliate with the stores then transfers its profits to the holding company through royalty payments that are deducted as a current expense. This effectively transfers income earned in the states where the stores are located (by a company with a very substantial physical presence in those states) to another state that might not tax that income. Currently, this is considered somewhat risky tax planning because some state courts have held such arrangements to be illegal. (See discussion below.) There could be substantial penalties and interest facing a corporation that loses such a case. If S. 2721 becomes law, that risk will disappear; a state would be prohibited from taxing the holding company to which the income earned in the state was shifted because the holding company would not have a physical presence in the state. Further, these shifting schemes would become not just standard, but required, tax planning due to the fiduciary duties that corporate boards of directors owe to their shareholders.

Others have noted the effect of S. 2721 on tax planning as well. Professor John Swain (University of Arizona) writes in the William and Mary Law Review that "the physical presence nexus test motivates taxpayers to avoid physical presence in some jurisdictions while shifting property and payroll to tax havens."[3] Likewise, a Congressional Research Service analysis drew this conclusion:

> "The new regulations as proposed in H.R. 1956 and S. 2721, would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have expanded the opportunities for tax planning and thus tax avoidance and possibly evasion."[4]

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[3] John Swain, "State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective," William and Mary Law Review, Vol. 45, Issue 1, 2003.

[4] Steven Maguire, ***State Corporate Income Taxes: A Description and Analysis***, CRS Report for Congress, Order Code RL32297, updated June 14, 2006, p.16.

The Center on Budget and Policy Priorities has also commented extensively on the undesirable effects of federal business activity tax nexus legislation and how it promotes inappropriate tax sheltering.[5] The Center has also examined challenged the arguments made in support of S. 2721, and that document is commended to you for review.[6]

Federal Anti-sheltering Activities. It is more than a little ironic and incongruous that Congress would consider legislation such as S. 2721 that promotes tax sheltering at the state level when it has, with the leadership of the Committee on Finance, taken a number of steps to eliminate or reduce the effects of sheltering under the federal income tax. Among the actions taken by this Committee and the Congress to combat federal sheltering are:

- Enactment of legislation establishing a "listed transactions" regime a registration requirement for listed transactions, notification to the IRS and an enhanced penalty regime for engaging in listed transactions;
- Support for several IRS Voluntary Compliance Initiatives for shelter participants that secure payment of taxes, interest and penalties due on shelter transactions in return for avoiding criminal prosecution and steeper penalties;
- Investigations into the role of tax shelter promoters and advisers in spreading the use of illegal shelter transactions;
- Efforts to codify the "economic substance" rule in order to strengthen the hand of IRS in dealing with sham transactions that result in sheltering;
- Investigations into the role of non-profits as parties to tax shelter transactions and consideration of remedial legislation;
- Efforts to identify the causes of the tax gap and to push Treasury and IRS to bring forth proposals to narrow the gap;
- The review of advanced pricing agreements and other international tax provisions in an effort to reduce tax planning and sheltering;

[5] See, for example, Michael Mazerov, "Proposed 'Business Activity Tax Nexus Legislation' Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy," Revised July 20, 2006. [Available at http://www.cbpp.org/9-14-04sfp-sum.htm. See also Michael Mazerov, "Federal 'Business Activity Tax Nexus' Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes," Revised May 9, 2005. Available at www.cbpp.org.

[6] Michael Mazerov, "Proponents Case for a Federally-Imposed Business Activity Nexus Standard Has Little Merit," Revised July 20, 2006. Available at http://www.cbpp.org/6-20-06sfp.htm.

Additional Examples. The following 4 scenarios were developed by a team of Kansas auditors, attorneys and policy analysts who met recently to evaluate the fiscal impact of HR 1956. These examples are equally relevant to S. 2721. They looked at the manufacturing, retail and service sectors of the Kansas business tax base, analyzed the proposed legislation, and then figured out how certain businesses could lower their taxes using the "safe harbors" to allow businesses that already have physical nexus with Kansas to substantially reduce their tax liabilities. The examples are drawn from testimony provided to the Commercial and Administrative Law Subcommittee of the House Committee on the Judiciary by Joan Wagnon, Secretary of the Kansas Department of Revenue on September 27, 2005. In Montana, a similar team of auditors, attorneys and analysts reviewed these examples and found them to be equally applicable and negative in their effects on the equity and integrity of our state tax base. We might substitute different industry examples, but the analysis and impact is the same.

Manufacturer scenario

Company A makes tires in Kansas and sells them nationwide. In order to take advantage of H.R. 1956 safe harbors, company A breaks itself up into several separate entities: company B owns/leases the plant facility and equipment in Kansas, company C, located out-of-state, owns/leases the materials used to make the tires, and company D employs the Kansas factory workers. All remain commonly owned. Under the safe harbor for manufacturing materials (up to the point those materials become the finished product/inventory), company C has no nexus with Kansas, and the value of the materials at the Kansas plant owned/leased by company C would appear to be excluded from the numerator of the property factor, thus reducing the Kansas apportionment factor, and Kansas' share of any taxable business income.

This same scenario could apply as well to an aircraft manufacturer in Kansas. An affiliated out-of-state entity owns/leases the materials (up to the point they become the finished product) being manufactured into aircraft. Another entity owns/leases the Kansas manufacturing facility, and yet another employs the Kansas factory workers. The owner of the materials and unfinished produced items would appear to be shielded from nexus under an H.R. 1956 safe harbor.

Retailer scenario

An out-of-state retailer of computers or other electronic devices markets its products to Kansas customers via the Internet. The sale of computers and electronic devices includes warranty contracts. The out-of-state retailer contracts with an independent contractor located in Kansas to provide the warranty service to its Kansas customers. The independent contractor provides similar services to other out-of-state retailers, all of which could be affiliates of one another. Under

> the independent contractor safe harbor in H.R. 1956, the out-of-state retailer now has no nexus with Kansas.
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> **Financial Services Scenario**
> Kansas financial services company H breaks itself into companies I and J, which remain in Kansas, as well as broker K, which is located out-of-state. Broker K services the Kansas customers of companies I and J via Internet, mail or telephone. Income earned by broker K on sales of financial services to Kansas customers will no longer be taxable by Kansas.
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> **Information/software Services Scenario**
> A Kansas company providing information and software support services to businesses in Kansas and other states breaks itself into in-state information services company X, in-state software support services company Y, and an out-of-state sales agency Z. Companies X and Y wholesale their services to agency Z, who in turn sells the services to businesses in Kansas, delivering the services via the Internet. Income earned by agency Z on sales of information and software services provided to Kansas customers will not be taxable in Kansas.

These scenarios do not, by any means, exhaust the examples of tax sheltering that would be legalized by S. 2721. The important point is that these and other cases constitute improper tax sheltering because in each instance they allow businesses to earn substantial profits in a state without paying taxes to that state on those profits, or in many instances to any state at all.

II. S. 2721 constitutes a huge unfunded mandate on states and localities. The Congressional Budget Office estimates that a substantially similar House bill (H.R. 1956) will reduce state revenues by $1 billion in 2007 and by $3 billion per year in 2011.

On July 11, 2006, the Congressional Budget Office released a cost estimate on H.R. 1956, the Business Activity Tax Simplification Act of 2005, the House counterpart to S. 2721. Some excerpts from that report follow:

> CBO estimates that enacting H.R. 1956 would result in revenue losses for states and some local governments and that such losses likely would total more than $1 billion in the first full year after enactment. We estimate that forgone revenues would grow to about $3 billion annually by 2011. (P. 3)
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> CBO expects that all states and some local governments would see an immediate

> revenue loss because they are currently collecting taxes from firms that would be exempt from taxation under the bill. This initial effect would likely exceed $1 billion, annually, nationwide. Subsequently, it is likely that 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. CBO expects that these reorganizations would occur during the first five years after enactment of the legislation and estimates that forgone revenues to state and local governments would likely total about $3 billion, annually, by 2011. (P. 4)
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> Overall, we estimate that about 75 percent of total income from BATs could be at risk under the bill. (P. 5)

While the estimate provided by CBO involves substantial revenues, state tax administrators believe it represents the low-end of the possible range of impacts, based on work done by states using tax return information and the knowledge they have of their state economies and taxpayer population. In a study released in September 2005 by the National Governors Association, states estimated that H.R. 1956 would reduce state revenues by $4.8 billion to $8.0 billion, depending on how widely the tax planning blessed by the bill was exploited by businesses. While the CBO and NGA estimates differ they both involve substantial sums of revenue, they are clearly on the same order of magnitude and they both indicate that the revenue losses from the bill grow as the companies adjust their operations to exploit the loopholes provided by the bill. Replacing the revenues lost from this bill will, of course, require reductions in vital services or a shifting of the burden to other taxpayers.

At the time of the NGA study, we estimated the impact in Montana as beginning in the first year at $3 to $6 million dollars and growing within five years to $25 to $35 million annually—or 30% to 40% of our corporate tax revenues . That revenue loss is equal to all of the money that Montana spends annually to operate our state mental health facilitates, or our state prison, or all of our services to needy families and children. Based on more recent trends in corporate revenues, the same 30% to 40% loss of corporate tax revenues now translates into an even larger $45 to $60 million dollar loss. This is more the enough money to operate our Montana Highway Patrol for two years, or our annual budget for the Department of Military Affairs that encompasses our National Guard and all state disaster and emergency preparedness expenditures, or all of our annual

institutional and rehabilitation services to persons with disabilities. Other states have reported similar estimates of large revenue losses over time as multistate and multinational companies restructure to take advantage of the tax sheltering opportunities in the legislation.

III. S. 2721 favors large businesses over small businesses and favors out of state corporations over in-state entities, distorts investment decisions and harms economic development efforts especially in rural states.

The planning opportunities presented by S. 2721 are not readily available to just any business; rather, the advantages offered by the bill are most likely not going to be available to small businesses. Those businesses will have to continue paying taxes that their larger competitors will be able to avoid. There is nothing in the bill that specifically limits its protections to larger businesses, but in practical terms, larger businesses will have more opportunities available to them to engage in the tax-planning activities discussed above. For example, a corporation cannot simply establish an affiliate in a low-tax state and assign all of its income to that affiliate; if that were to happen, the original taxing state could disregard the second corporation as a sham. Instead, there must be at least the appearance of a business purpose for setting up that second corporation, and that appearance is more available to larger corporations that will be able to segregate various operations, for example, by having their trademarks put into another entity and then licensed back to the original operating entities. Mom-and-pop operations most likely don't have those options, and most likely don't have the resources to pay for the tax-planning services necessary to develop and implement them.

S. 2721 would allow corporations that can conduct business online or through other remote means to exploit the market in that state with all of the services it may offer and that may also be offered by in-state businesses, and not have to pay that state's corporate taxes, while the in-state businesses must pay the taxes. For example, under this bill, a state would be prevented from taxing an online seller of computers and electronics that separately incorporates its warranty and repair functions as an independent contractor, so long as that independent contractor also contracts with another customer, which could be another affiliated company. The seller would be able to exploit the in-

state market, including providing the support services that are essential to maintaining its market, without being taxable in the state, while in-state sellers would be subject to tax. Or, a bank that has the capacity to offer all of its services online would be able to provide those services to every citizen of a state from outside the state, without opening a branch in that state, and yet never have to pay any corporate taxes to that state. These are just two examples of out of state entities that could leverage economies of scale to exploit a market in a state without being physically present there, while gaining the competitive advantage of not having to pay that state taxes, as the in-state companies that open offices and provide jobs to that state's citizens would have to do. That makes S. 2721 not only patently unfair, but also a strong deterrent to companies considering actually moving into the states, with buildings and jobs, where they conduct their business and derive their profits.

S. 2721 acts as a barrier to the flow of new investment and economic development into states.. As stated by Elizabeth Harchenko, Director of Revenue for the State of Oregon and former Chair of the Multistate Tax Commission:

> In an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[7]

IV. S. 2721 does great harm to our federal system and overturns existing constitutional precedent on state jurisdiction to tax.

S. 2721 runs roughshod over federalism, placing Congress in the position of imposing a federally-mandated jurisdictional standard on all states that will create innumerable opportunities for multistate entities to avoid state taxes. For almost 230 years, while maintaining its jurisdiction over interstate commerce, Congress has consistently respected the right of states to raise revenues from economic activity

[7] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001

occurring within their borders. It has generally refrained from preempting state tax authority except when certain federal interests or the interests of interstate transportation industries (narrowly construed) were involved. With S. 2721, Congress is being asked, without the benefit of any justification or investigative hearings as to the need for such legislation, to overturn the current constitutional "doing business" standard that has governed the imposition of state business activity taxes and replace it with a "physical presence" standard that is not required under current standards and that promotes tax planning and sheltering.

Some proponents of S. 2721 have indicated that the bill merely provides necessary, common-sense clarifications as to what constitutes a physical presence, and that such a bill is needed to clarify what they say is the current state of the law, i.e., that a state may only impose a business activity tax on a business conducting interstate commerce when that business has a physical presence in the state. Such statements, however, are simply not true. Current law does not require a physical presence in the state. This has been made clear by the best source possible, the United States Supreme Court. In *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), a decision affirming that a physical presence is required to satisfy the "substantial nexus" standard for sales and use taxes, the Supreme Court specifically said (twice) that it had never applied the physical-presence standard to other taxes. In addition, S. 2721 would negate U.S. Supreme Court decisions involving attributional nexus through independent contractors, including *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232 (1987), a decision upholding the imposition of Washington's business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor.

The "doing business" standard has been successfully defended in the courts of many states. At last count, courts in at least eight states had upheld the "doing business" standard, and the U.S. Supreme Court had denied *certiorari* in at least two instances

where a state court has upheld the "doing business" standard.[8] S. 2721 would have the effect of reversing these state court decisions. Such encroachment on state tax authority clearly violates the most basic principles of federalism upon which our Nation was built.

Beyond the federalism aspects, the "doing business" standard is a far more appropriate jurisdictional and nexus standard than the physical presence one proposed in S. 2721. It diminishes the ability of businesses to exploit a state's marketplace without incurring tax liability, thus avoiding an adverse impact on smaller, locally-owned businesses. In addition, the doing business standards assures that states have the authority to tax income where it earned.

V. The expansion of P.L. 86-272 is unwarranted and runs counter to the direction that the economy is going.

Public Law 86-272 (15 U.S.C. section 381) prohibits a state from imposing its net income tax on a business whose only activity within the state is the solicitation of orders of tangible property, provided that the orders are approved and the goods are shipped to the purchasers from outside the taxing state. The law was written to respond to complaints from the business community in response to the 1959 Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) that expanded the authority of states to impose nondiscriminatory, fairly apportioned net income taxes on interstate businesses. At the time it was written, Public Law 86-272 was considered as a temporary measure that allowed Congress time to study the issue. The House Judiciary Committee created the Special Subcommittee on State Taxation of

[8] Those court decisions include: Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993); 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); 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); General Motors Corp. v. City of Seattle, 25 P.3d 1022 (Wash. Ct. App. 2001), cert. denied, 122 S.Ct. 1915 (2002); Kmart Properties, Inc. v. Taxation and Revenue Dept., No. 21,140 (N.M. Ct. App. 2001), cert. quashed (N.M., 12/29/05); Lanco, Inc. v. Director, Division of Taxation, No. A-3285-03T1 (N.J. Super. Ct. App. Div., 8/24/05); Geoffrey, Inc. v. Oklahoma Tax Commission, No. 99,938 (Okla. Ct. Civ. App., 12/23/05); and, Borden Chemicals and Plastics, L.P. v. Zehnder, 726 N.E.2d 73 (Ill. App. Ct. 2000), appeal denied, 731 N.E.2d 762 (Ill. 2000). For further discussion, see Federation of Tax Administrators, "The Current Law Standard of Nexus for Business Activity Taxes," February 23, 2006.

Interstate Commerce also known as the Willis Commission for this purpose. The Willis Commission's report was issued in 1964 but no legislation came from the report and Public Law 86-272 is still on the books.

S. 2721 would expand the scope of P.L. 86-272 by bringing all forms of business activity taxes (not just net income taxes) within its purview and by making all types of sales (i.e., those involving intangibles and services as well as tangible property) subject to its provisions.

P.L. 86-272 in its current limited form is often criticized as providing a tax planning tool to aggressive companies and for lacking any basis in sound tax policy or economic theory. Professor Charles McLure of the Hoover Institution at Stanford University, a noted expert in public finance, in an article in the December 2000 *National Tax Journal*, Professor McLure states:

> "Current rules for determining income tax nexus fail miserably. P.L. 86-272 has been justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income taxes from corporations deriving income from within their borders."[9]

Given its current flaws, it makes no tax policy sense to extend the scope of P.L. 86-272. As technological change enables a growing number of businesses to conduct many of their operations through remote means, expanding P.L. 86-272 will allow more and more businesses to establish and maintain markets in a state without bearing any tax burden in the state. Under an expanded P.L. 86-272, a company could have as many employees in the state for as long as it wanted, driving as many vehicles as it wanted and not be subject to tax as long as the employees confined their activities to solicitation and the goods were shipped into the state from outside (even if in the company's trucks.) An entirely in-state small business would, on the other hand, be taxed on all its activities in the state. This creates unfair competition with in-state businesses and erodes state tax

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[9] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume LIII, No. 4, Part 3, December 2000, p. 1297.

bases. It seems rather anachronistic to expand P.L. 86-272 in an era when the ability to operate remotely is increasing on a daily basis, and geographic boundaries are relatively meaningless to the manner in which a business operates.

VI. The states have developed an objective, simple bright line nexus standard that makes economic sense, protects small businesses and is understandable by all concerned. The business community has summarily rejected that proposal.

The Multistate Tax Commission's Factor Presence Nexus Standard for Business Activity Taxes[10] (Policy Resolution 02-02) is formulated to provide a "bright-line" standard governing the jurisdiction of states to impose business activity taxes on an enterprise that is doing business in their state. In addition to providing a "bright-line" nexus standard, the factor presence nexus standard would reduce compliance costs for both multistate businesses and state tax administration agencies because the basis of the nexus standard would be based on dollar amounts of sales, payroll, and property -- the factors currently used to apportion a business' net income among the states in which it does business – rather than the myriad "doing business" standards currently used by the states. That is, a multistate state business, not domiciled in a state, would have nexus in that state, if and only if, the level of sales, or payroll, or property (the definition of these factors are contained in the Policy Statement 02-02), exceeded a certain threshold. The threshold levels would relieve businesses from filing income tax returns in states in which they have little economic activity.

The threshold levels in Policy Resolution 02-02 were set at $500,000; and $50,000 for sales, and payroll and property respectively. The threshold level would also be met if the dollar level of any of the factors in that state, relative to that company's total dollar level of the factor were equal to or greater than 25 percent. The dollar threshold levels would be adjusted according to annual changes in the Consumer Price Index published by the U.S. Bureau of Labor Statistics to prevent the real value of the thresholds from the ravages of inflation. To date, only Ohio has formally adopted the

[10] The National Governors Association and the Federation of Tax Administrators do not have specific policy addressing the MTC factor presence nexus standard.

factor presence nexus standard. However, other states are considering this standard for adoption.

The genesis for this nexus standard was based on the discussion of nexus standards set out by Professor McLure, stated his views on proper nexus standards at an MTC seminar on Federalism at Risk and in an article published in the *National Tax Journal*.[11] The principle stated by Professor McLure is:

> "Thus in determining nexus for income tax, it is appropriate to ask whether the potential taxpayer conducts significant amounts of whatever economic activity would give rise to income tax liability if conducted by a profitable taxpayer – that is, whether the taxpayer conducts significant amounts of economic activities that are factors in the state's apportionment formula (e.g., payroll, property, and sales)."
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> "It would not be satisfactory merely to specify in general terms that significant amounts of in-state property or sales would be required for nexus; that leaves too much uncertainty and too much room for litigation. There should be quantitative bright line tests based on the minimum amounts of each factor needed to establish nexus."

Adoption of a factor-based nexus standard as proposed by the MTC would provide a clear, understandable bright line nexus standard for business activity taxes. The business community has rejected the proposal.

Conclusion

The economy of the 21st Century is electronic and borderless. Most businesses can operate anywhere and anytime without the encumbrance of physical presence. Technological developments have completely reshaped the manner in which business is conducted. Consequently, the business that utilizes modern technology to maximize a state's market may have no less of a presence in the state than the business that establishes a physical presence.

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[11] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume 53, No.4, Part 3, December 2000, p. 1296.

That is why the current standard of economic presence, taking into account property, sales and payroll, is fair. As Professor Swain points out, "equity is enhanced by economic nexus because economic nexus ensures that similarly situated taxpayers are treated the same, both within each state and nationally."

S. 2721 takes 19th Century tax law and imposes it upon the 21st Century electronic, borderless economy. It replaces economic presence with "headquarters-only" taxation. It is a colonial concept of taxation wherein a company can receive the benefits a state offers without making a fair payment.

How does a multistate company with economic presence in a state receive benefits that state has to offer? It benefits from an enhanced market when a state's residents are educated by a state educational system paid for by state revenues. It benefits when it can adjudicate disputes in a state court system paid for by state revenues. It benefits when its trucks travel on that state's roads with that state's law enforcement officers keeping the road safe to transport that company's goods.

There is no compelling need for federal preemption of state and local law by switching from a system that works to a system that does not work. If change is needed, the states through the MTC factor presence nexus standard have brought forth a better idea.

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to present this testimony. Please do not support S. 2721.

Response of Dan Bucks to a Question from Senator Ron Wyden

Advocates for H.R. 1956/S.2721 say the measure will simplify the determination whether a business has enough connection to a state to be obligated to pay tax. Wouldn't the factor presence nexus proposal discussed in Mr. Bucks' testimony provide simplicity with more consistency than these bills provide.

Answer: Yes, the Factor Presence Nexus Standard is a model of simplicity and clarity. The definitions of the factors that determine nexus are identical to those currently by states to apportion income, thus producing these results:

1. ***Greatly Simplified and More Equitable Compliance as Compared to H.R. 1956 and S. 2721.*** *The factor presence proposal requires no new recordkeeping by companies because they already keep records on the amount of property, payroll and sales by state for income apportionment. States have established procedures for verifying the validity and accuracy of those records, ensuring that honest taxpayers will not be disadvantaged by taxpayers who are not. The factor presence proposal maximizes taxpayer ease and convenience and ensures consistent and equitable compliance.*

   In contrast, H.R. 1956 and S. 2721 would require voluminous and complex record keeping concerning the location of individual employees, contractors and property on a daily basis, the type of activities being conducted by employees and contractors, the extent of business relationships that contractors have both with the taxpayer and other parties, and the type of uses to which property would be placed. States have no established procedures for verifying the validity and accuracy of this information and it is unlikely that they would be able to develop effective systems of verification. H.R. 1956 and S. 2721 would greatly increase the cost and complexity for both taxpayers and states and would, because of the inability of states to verify information, reward dishonest taxpayers at the expense of honest taxpayers. Thus no separate records, measurements or definitions are necessary making taxpayer compliance and administration much easier than under H.R. 1956 and S. 2721.

2. ***The Factor Presence Nexus Standard Proposal is Consistent with the Principle that a Company Pays Taxes to a State Where it Earns Income and is Consistent With Recent State Court Decisions.*** *Under the Factor Presence Nexus Standard, a company would be liable for income tax in a state only if it earns income in that state at more than a de minimis level. It would equitably and consistently exempt from a state's tax any companies with minor levels of business activity that would not result in the earning of any significant income. Small businesses would be protected because the threshold levels for the apportionment factors are sufficiently high. Further, the thresholds would be changed periodically to keep pace with price level changes to prevent smaller out-of-state businesses from being subject to a states' business activity tax over time.*

   Recently, courts in Oklahoma, North Carolina, New Jersey, New Mexico, South Carolina and West Virginia have upheld the principle that out-of-state corporations should pay income taxes in the states in which the company earns significant income. Physical

*presence has **not** been required for the purpose of establishing state income tax applicability.*

In comparison, the arbitrary nexus rules in H.R. 1956 and S.2721 will produce inconsistent tax treatment for companies that earn the same amount of income in a state . The proponents of these bills claim that they merely want to modernize Public Law 86-272 and extend these protections to the sales of services and intangibles. However, the result will be inequities in the treatment of taxpayers. For example, two companies with similar levels of income earned in a state can be taxed differently because of the arbitrary nature of the proposed physical presence rules. One out-of-state company can have an unlimited number of employees in a state, for any purpose, for fewer than 21 days and not create nexus; and therefore would not be subject to that state's income tax. In contrast, another company can have a single employee in a state for 22 days and that will create nexus subjecting that company to that state's income tax. An egregious example of the inconsistencies contained in H.R. 1956 and S.2721 is the treatment of individuals and businesses that provide services to real property. Consider the roofing contractor that operates in a multistate environment. This small business can come into a state in which it has a license to do roofing work for a large home building firm. Under S2721, states can assert nexus over this small roofing firm as soon as the truck carrying the roofer, the supplies, and any employees crosses the state line. In contrast, a firm that does not provide services to real property and earn significant amounts of income can have an unlimited number of employees in that state for fewer than 21 days and would not have created nexus.

The arbitrary nature of the rules proposed in S2721 will invite manipulation of those rules for tax planning purposes, further undermining the equity and integrity of the income tax system. A recent analysis by the Congressional Research Service of these bills reinforces our findings concerning the inappropriateness of extending PL 86-272 to the sales of services and intangibles:

> *"The new regulations as proposed would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have expanded the opportunities for tax planning and thus tax avoidance and possibly evasion."*[1]

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[1] Steven Maguire, ***State Corporate Income Taxes: a Description and Analysis, Updated June 14, 2006,*** ORDER CODE RL 32297 CRS Report for Congress, pp. 15-16.

Response of Dan Bucks to Questions from Senator Orrin Hatch

Question 1. Mr. Bucks, can you give us an example of how a large multi-state business could exploit the provisions of S. 2721 to avoid state taxation in ways that are not possible now?

Answer to Question 1. In my prepared testimony, I provided a number of examples of how large, multistate businesses can exploit the provisions of S.2721 to avoid state tax income taxation that are not possible now. There are many additional opportunities for a large, multistate business to exploit the provisions of S2721 to avoid income taxation in ways that are not currently allowed. By prohibiting a state from taxing any entity that does not maintain any of the listed types of physical presence in the state, the bill provides, and shields from state taxation, any number of opportunities to structure corporate affiliates and transactions to avoid state taxes.

1. *For example, one of the more common such schemes is the use of intangible holding companies to shift income of a retailer with many stores in each state away from those states. The trademarks of the retailer are assigned to a holding company established in a low-or-no-tax state, and the affiliate with the stores then transfers its profits to the holding company in the form of royalty payments, thereby transferring income earned in the states where the stores are physically located, the income is earned and the company has a substantial physical presence, to another state that might not tax that income. The affiliate with stores in the state deducts the royalty as a current expense, thus completing the income shift. The end result is that the income earned in the states where a physical presence exists (stores and employees) would, under S2721, be shifted outside those states to an affiliate with no physical presence in the state where the income is earned and should properly be taxed.*
2. *Some corporations then lend the money from the holding company back to the affiliate with the stores. This, in turn, generates a corresponding interest paid deduction for the affiliate with stores and further reduces any income that may have been reflected on the books of the affiliate with the stores in the state.*

Currently, this type of tax planning could be considered "not possible" because many states are disallowing this income shifting and winning their cases in court. See, e.g., Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993); 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); Kmart Properties, Inc. v. Taxation and Revenue Dept., No. 21,140 (N.M. Ct. App. 2001), cert. quashed (N.M., 12/29/05); Lanco, Inc. vs Director, Division of Taxation, 908 A2D176 (NJ 2006); and Tax Commissioner vs MBNA America Bank, 640 S.E. 2d 226 (W. VA. 2006). This use of intangible holding companies to shift income is currently considered risky tax planning because no court in which it has been reviewed has allowed it.[1] If S. 2721 were to become law, a state then would be prohibited from taxing the holding company to which the income earned in the state was shifted because the holding company would not have any of the bill's specifically enumerated types of physical presence in the state. Further, by making intangible holding companies "bullet proof" from a state tax standpoint, S. 2721 would virtually require any corporation not now using an intangible holding

[1] Arguably the J.C. Penney case in Tennessee is an exception.

company approach to adopt one, due to the fiduciary duties corporate boards of directors owe to their shareholders.

The use of intangible holding companies is of growing concern to federal tax administrators as well. A November 7, 2005, Wall Street Journal article[2] chronicled how various computer software and pharmaceutical companies are substantially reducing their federal tax liabilities by situsing profits from their product licensing activities in low tax countries such as Ireland. IRS and Treasury are pursuing the collection of tax on shielded profits through both litigation and regulation according to the article. The impact of intangible holding companies demonstrates the natural outcome of situations in which artificial barriers and constructs (e.g., physical presence requirements) conflict with attempts to tax based on economic realities and where income is actually earned. S. 2721 would legalize this income shifting approach that numerous state courts have determined to be in violation of their laws.

It has been argued that states have other approaches they can use to limit the impact of intangible holding companies such as combined reporting and "add-back" statutes. These are only partial remedies and only where there is an affiliate that does have nexus in the state. It must be considered, however, that there is no guarantee that such approaches would continue to prevail in the face of a federal statute mandating physical presence. Moreover, it is simply not the function of Congress to put the states in the position of having to adjust their tax laws to react to federal preemptions that bless tax sheltering.

Question 2. Mr. Lindholm testified that many states have become far too aggressive in asserting nexus to out-of-state businesses. Do you agree that some states are going too far over the line?

Answer to Question 2. No. State "doing business" standards date back several decades and are typically based on an economic presence standard. The only change in recent years is efforts by large, multistate corporate businesses to assert a new physical presence theory as a means of avoiding income taxation in states where they earn substantial income. As a result, numerous cases have been litigated in state courts. The overwhelming majority of these cases (see previous citations) have upheld the states' traditional doing business standards.

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[2] Glenn R. Simpson, "Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in the U.S. and Europe." Wall Street Journal, November 7, 2005, p. A-1.

Response of Dan Bucks to Questions from Senator Charles Schumer

Question 1. In the Supreme Court decision in the *Quill* case, the Court decided that a physical presence standard makes sense in the case of the imposition of sales and use taxes. Can you explain why a different standard should be applied in the case of business activity taxes?

Answer to Question 1. The question seems to assume the current proposed legislation would adopt physical presence. But in fact in Quill, and other cases (Scripto and Tyler Pipe), the court has said physical presence can be created through activities of representatives furthering the taxpayers interests in the state. S2721 would greatly restrict representational nexus and thus is not even consistent with the extent of nexus allowed in Quill and these other cases.

Furthermore, Quill Corp. v. North Dakota, 504 U.S. 298 (1992) did not hold that the physical-presence standard "makes sense" in a sales and use tax context. It would be more accurate to say that the Court reluctantly agreed to continue the standard set by its previous decision in National Bellas Hess v. Illinois Department of Revenue 386 U.S. 753 (1967) out of respect for the principle of stare decisis and because the mail-order industry arguably developed some reliance on that way of doing business. The following passage from Quill bears that out:

> *... [T]he Bellas Hess rule has engendered substantial reliance and has become part of the basic framework of a sizable industry. The "interest in stability and orderly development of the law" that undergirds the doctrine of stare decisis, therefore counsels adherence to settled precedent.*
>
> *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, our reasoning in those cases does not compel that we now reject the rule that Bellas Hess established in the area of sales and use taxes. To the contrary, the continuing value of a bright-line rule in this area and the doctrine and principles of stare decisis indicate that the Bellas Hess rule remains good law. For these reasons, we disagree with the North Dakota Supreme Court's conclusion that the time has come to renounce the bright-line test of Bellas Hess.*
>
> *This aspect of our decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions. Indeed, in recent years Congress has considered legislation that would "overrule" the Bellas Hess rule. Its decision not to take action in this direction may, of course, have been dictated by respect for our holding in Bellas Hess that the Due Process Clause prohibits States from imposing such taxes, but today we have put that problem to rest. Accordingly, Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes. 504 U.S. at 317-318. (Citations and footnotes omitted.)*

As to why a standard other than physical presence should be applied in the case of business activity taxes, the answer is simply that this reliance consideration does not exist with regard to other taxes. The court did not say that a standard other than physical presence should apply to other taxes. It only said that it has not said anything about other taxes. In fact, in Quill, the Supreme Court specifically said that it had never applied the physical-presence standard to other taxes: "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 ..." (504 U.S. at 314); 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 317). These statements indicate that not only that the Court considered the physical-presence standard to be more rigorous than the nexus standards it had applied to other taxes, but that the Court itself determined that a different standard could be applied for purposes of taxes other than sales and use tax.

Supreme Court decisions notwithstanding, there are arguments against a physical presence-based nexus standard for business activity taxes in general. Professor Charles McLure, an eminent scholar of the economics of the public sector at Stanford University's Hoover Institute, stated that Public Law 86-272 does not provide a desirable basis for state business activity nexus. In an article in the December 2000 ***National Tax Journal****, he wrote:*

> *"Current rules for determining income tax nexus fail miserably. P.L. 86-272 has been justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income taxes from corporations deriving income from within their borders."*[1]

In addition, there are two bills currently being debated by Congress, S. 2152, sponsored by Senator Enzi, and S. 2153, sponsored by Senator Dorgan, entitled, "A bill to promote simplification and fairness in the administration and collection of sales and use taxes." If either of these bills is enacted, physical presence will no longer be the nexus standard for use taxes. Nexus for collection of use taxes by out-of-state sellers will be based on a de minimis level of sales – as we propose for Business Activity Taxes under the Factor Presence nexus standard.

Question 2. Mr. Bucks, your testimony indicates that you support the notion that states should impose business activity taxes based on an economic nexus standard, rather than a physical presence standard. If every state followed this logic, how could a business that has customers throughout the United States avoid being taxed everywhere on the same income?

Answer to Question 2. A business that has customers throughout the United States is not taxed on the same income because states impose their business activity tax on income that has been apportioned to it, not the total amount of net income. The standard formula for apportioning income to a state is one in which the total level of net income of the firm is multiplied by the level of sales in that state relative to the firm's total U.S. sales; the level of payroll in that state,

[1] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume LIII, No. 4, Part 3, December 2000, p. 1297.

relative to its total U.S. payroll, and the level of property in that state, relative to its total U.S. property. Each of those ratios is multiplied by an apportionment factor weight; the sum of the factor weights must equal one (1).[2] *The sum of the income apportioned to each state should equal the total net income of the business.*[3]

In the rare case that the same income may be taxed by more than one state due to variations in some apportionment and allocation practices, the Multistate Tax Commission has established an Alternative Dispute Resolution program in the 1990's in which the company can appeal a case of multiple taxation. To date, no large multistate corporate taxpayer has availed itself of this service, thus indicating that few, if any, material cases of multiple taxation actually exist.

Despite differences in apportionment formulas and definitions of apportionment factors among the states, the probability of multistate businesses incurring multiple taxation is small. A study by Salvador Lopez and Jorge Martinez-Vazquez found that in the aggregate, business income was under-apportioned by 3 percent between 1972 and 1987. Of all major industry groups, only textile mill products and tobacco products incurred over-apportionment of income in that period. The degree of over-apportionment for those industries was 1 percent and 2 percent respectively for that 1972-87 period.[4]

The evidence from the practical experience of no major cases of multiple taxation being brought forward to the states for resolution and the academic research on the subject indicates that overall consistency of state division of income for tax purposes operates to minimize the risk of multiple taxation.

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[2] In mathematical terms, the income of a company that earned $X that can be apportioned to any state can be written as:

$$X_{ij} = X_J * \{(\alpha_i *(S_{ij}/S_J)) + (\beta_i * (L_{ij}/L_J) + (\gamma_i * (P_{ij}/P_J))\}$$

Where:
X_{ij} is the net income of company (j) apportioned to State (i).
X_J is the total net income of company (j).
α_i is the weight of the sales factor in state (i).
S_{ij}/S_J is the ratio of sales of company (j) in state (i) to the total sales of company (j).
β_i is the weight of the payroll factor in state (i).
L_{ij}/L_J is the ratio of payroll of company (j) in state (i) to total payroll of company (j).
γ_i is the weight of the property factor in state (i).
P_{ij}/P_J is the ratio of property of company (j) in state (i) to total property of company (j).
$\alpha_i + \beta_i + \gamma_i = 1$

[3] If all states used the identical apportionment formula, the sum of the net income apportioned to each state would equal the net income of the firm.
[4] Salvador Lopez and Jorge Martinez-Vazquez, "State Corporate Income Taxation: An Evaluation of the Formula Apportionment System, National Tax Association, ***Proceedings of the Ninetieth Annual Conference, 1997***, p. 157.

Question 3. How successful has Montana been in imposing and successfully collecting tax based on economic nexus theory?

Answer to Question 3. Multistate business taxpayers comply voluntarily on a widespread basis, without enforcement, with Montana's economic presence standard—a standard that has been part of this state's law for decades. In 2004, nearly half (47%) of all the multistate corporations filing returns in Montana had no or de minimis levels of physical presence in Montana. These corporations were filing because they had either exclusively or overwhelmingly an economic presence in the state by virtue of making sales to customers in Montana. These corporations are filing voluntarily in Montana. Our state has undertaken no special nexus enforcement or education activities in the past decade. These corporations voluntarily recognize that economic presence is not a theory, but the law as established in Montana statutes and under a proper reading of U.S. Supreme Court jurisprudence. So Montana has been very successful in securing voluntary compliance with its economic presence law—a law that has been on the books for several decades—without having to undertake any special enforcement of that law.

Tax year 2004 is used for this answer because it is the most recent year for which the Montana Department of Revenue has compiled statistics from all corporate tax returns. The actual numbers are as follows: 3,413 multistate corporations filed returns in Montana in 2004. Of these, 991—29% of the total multistate corporations—made sales into the state, but had absolutely no physical presence in Montana (i.e. zero property or payroll). An additional 604 corporations—or 18%—had de minimis physical presence in Montana (as measured by the proposed factor presence standard). Altogether, 1,595 corporations, or 47% of all multistate corporations filing in Montana, had either no or a de minimis level of physical presence in Montana in 2004.

These corporations presumably recognize a fiduciary responsibility to their shareholders to file returns only in states where they have nexus. These 1,595 corporations would not be filing in Montana if they did not recognize economic presence as established law. The actual, real world voluntary filing activity of this large number of corporations disproves the claim of the relatively small number of corporations advocating S 2721 and HR 1956 that there is doubt or uncertainty about the current state of the law with respect to nexus for state business activity taxes: economic presence, not physical presence, is the recognized standard.

Question 4. Mr. Mundaca testified that the physical presence standard has basically become the norm in the case of international taxation and U.S. tax treaties. International guidelines appear to recognize that any other standard will promote double taxation of multinational businesses. If the international community has figured this out, why should the states utilize different and inconsistent standards?

Answer to Question 4. States use different nexus standards than the federal government because states have a substantially different system of taxing multijurisdictional corporations. They also respectfully disagree with those who developed the Permanent Establishment (PE) standard in the 1920s that it is unfair to tax corporations that have substantial sales within their borders if they are not also "substantially physically present."

In his testimony, Mr. Mundaca makes clear that with respect to federal tax law itself, "the U.S. trade or business rules have no explicit requirement of physical presence" for tax jurisdiction over foreign corporations earning income in the United States and have at times been interpreted by the courts to not require direct physical presence of the selling corporation to find that jurisdiction exists.

While "physical presence" is indeed the standard under most bilateral tax treaties, Mr. Mundaca makes clear (p. 4) that the fundamental rationale for the PE standard, adopted in the 1920s, was the belief that it was inappropriate and unfair for nations to tax foreign corporations that merely had customers within their borders, not to prevent double taxation. While the PE standard, as Mr. Mundaca says, "helps to mitigate double taxation," that was not the original rationale or its prime role in the U.S. international tax system. The prime mechanism for preventing double taxation is the foreign tax credit. U.S. corporations are subject to tax on their worldwide income, with a credit against that liability for tax paid on the portion of that income that is earned abroad. States use a completely different mechanism to avoid double taxation, namely, mutually-agreed upon formulas to apportion the income of both corporations headquartered within their borders and corporations headquartered outside their borders to the states in which the corporations do business. As stated in the response to question number two, encouraging more uniform formulas is the appropriate means to prevent multiple taxation.

Mr. Mundaca himself acknowledges that there are a number of good "arguments in favor of a new standard that moves away from reliance on physical presence":

> *"It is difficult to deny that the global economy, business models, and technology have changed over the last 80 years in ways that bear direction on the theoretical and practical justifications for basing income tax jurisdiction on physical presence. For example, the connection between the physical location of business activities and the physical location of the customer or other sources of business income has become increasingly attenuated. In addition, more and more goods, and more and more value, in the new economy are intangible and therefore not clearly located in any particular physical location."*

In the final analysis, Mr. Mundaca does not assert that the states should conform to the PE standard. He simply says that "we should strive for uniform, predictable, and clear jurisdictional rules that minimize double taxation and that are easy to comply with and administer." The Multistate Tax Commission's proposed "factor presence nexus standard," discussed in my response to Senator Wyden's question, fully embodies and realizes those objectives.

Question 5. In your testimony you claim that "tax shelters allowed by this bill will allow many multistate and multinational companies to reduce their state tax liabilities to virtually zero." What sorts of tax shelters are you referring to that would enable these companies to virtually eliminate their state tax liabilities? How would the bill enable these tax shelters?

Answer to Question 5. My testimony was offered in the context of corporate income and other general business taxes, and my reference to state tax liabilities being reduced by some companies to virtually zero is for those taxes. Some examples of the tax shelters to which I

referred are in my written testimony on pages 7-8. The following examples are in addition to examples included in my written testimony.

1) *A simple example of the types of tax shelters is the use of an out –of-state intangible holding company (see attachment). Initially, a Parent Co sells $20,000,000 worth of goods to its retail subsidiary in New York State through a wholesale supplier in State A. The out-of-state supplier has expenses of $18,200,000 and a profit of $1,800,000. The NYS subsidiary sells those goods for $26,000,000; has expenses of $25,000,000; and a net profit of $1,000,000. The retail subsidiary pays a net income tax to NYS of $75,000. After S. 2721 is enacted, the out-of-state supplier raises the prices to the NYS retail grocer subsidiary to $20,740,000, and charges a royalty payment for the use of the trademark of $260,000 – 1.0 percent of sales. Under this scenario, the exact same total net income is shifted to the out-of-state supplier subsidiary – the profit reported in NYS is now $0.00. NYS cannot assert nexus over the out-of-state subsidiary for leasing an intangible – the use of the trademark In all likelihood, NYS auditors would not be able detect the use of the change in transfer prices to shift income out of NYS. Please see the attached March 20th statement of Senator Charles Grassley outlining the inability of the IRS to stop the aggressive use of the transfer pricing mechanism in the international sphere; and, the article by Martin Sullivan which shows how the net income of U.S. multinational businesses has been shifted to tax havens over the past 40 years.* [5]

2) *The second example uses S. 2721, Section 3 (2) [using 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] to shift income out of the state in which the income is earned. In this example, the Parent reorganizes the out-of-state supplier into two operating units. The operating units use the NYS affiliate to sell into NYS. Each affiliate charges the NYS grocer $10,370,000 and the NYS grocer sells the products for $26,000,000. The cost-of-goods-sold for the NYS grocer is $20,740,000; rent and wages add another $5,000,000 to costs; and royalties and management fees are $260,000. Total net income of NYS operations are $0.00. All net income is effectively shifted out of NYS by use of sophisticated transfer prices, and payments of royalties and management fees. Under S. 2721, only the in-state affiliate has nexus in NYS.*

3) *An example of a multistate business restructuring itself to take advantage of both federal and state tax laws to eliminate its state tax liability is AutoZone, Inc. In 1995, AutoZone changed its structure. AutoZone Inc., became a holding company that owned several subsidiaries including a company that provided management services and a company, AutoZone Development Corp. that owned the retail stores, and a Real Estate Investment Trust (REIT). The REIT leased the stores to AutoZone Development. The individual stores took a deduction for the rent paid to the Development Company. The rental*

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[5] Statement of the Senator Chuck Grassley, "Revenue Raisers Related to Offshore Schemes," Delivered Tuesday March 20, 2007. Tax Analysts, Inc, Falls Church, VA, Doc2007-7050; and Martin Sullivan, "A Challenge to the Conventional International Tax Wisdom," ***Tax Notes,*** December 11, 2006, pp. 951-961, Tax Analysts, Inc. Falls Church, VA. © 2007 Tax Analysts. All rights reserved. Protected by the copyright laws of the United States and international treaties.

income of the development company was passed through to the out-of-state owners. The Louisiana Department of Revenue assessed income taxes against the REIT for the dividends received by operations in Louisiana. The REIT took the position that Louisiana lacked jurisdiction. This position was upheld in the trial court, but it was subsequently rejected by the higher court. Under S2721, this type of tax sheltering would be allowed.

4) *Income can also be sheltered from taxation in the state in which the income was earned through the creation of a Passive Investment Company (PIC). In a simple example, a parent company establishes a holding company and assigns ownership of the company's trademarks and logos to this holding company. The PIC charges the operating units a fee or royalty payment to use the parent company's trademark, logo, or patent. Frequently, the PIC will lend funds from the royalty payments back to the operating units, at interest. The PIC's are usually located in state that does not impose an income tax on income generated by intangible assets; e.g., trademarks, patents, logos, and securities.*

It is not possible to know the full amount of income that is shifted to on-shore "tax havens" because corporations are not required to publicly disclose payment of royalties and interest to their affiliated PIC's. From recent court cases it appears the amount of income that can be shifted through the use of PIC's can be huge. In one case, nine wholly-owned subsidiary PICs of the Limited, Inc. received royalty and interest payments and interest from their affiliates in the amount of $423,098,963 in one year.[6] *Toys R'Us shifted $55 million to a PIC by charging the stores a royalty for the use of the logo and trademark, and for management fees for merchandising skills.*[7] *Kmart stores shifted approximately $250 million per year from 1991 through 1995 to the Michigan PIC through royalty payments. In addition, the PIC earned $78 million in interest payments from the stores during this period by lending the royalty receipts back to the stores.* [8] *Syms' transferred approximately $59 million in royalty payments between 1986 and 1991 to its Delaware affiliate that held its trademarks.*[9]

Furthermore, these PIC's often demonstrate little, if any, economic substance. The nine Limited PICs had no employees and shared office space, equipment, and supplies.[10] *Their listed primary office space in Delaware was also the primary office address of approximately 670 other companies unrelated to the Limited or its wholly-owned subsidiaries.*[11]

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[6] *A&F Trademark, Inc.*, 605 S.E. 2d 187, 189.
[7] *Geoffrey, Inc. vs. South Carolina Tax Commission*, State of South Carolina Supreme Court, Opinion No. 23886, July 6, 1993.
[8] *In the Matter of Kmart Properties, Inc.*, decision of New Mexico Department of Revenue and Taxation Hearing Officer No. 00-04, January 31, 2000.
[9] SYMS CORP. vs. COMMISSIONER OF REVENUE. SJC-08513 SUPREME JUDICIAL COURT OF MASSACHUSETTS *436 Mass. 505; 765 N.E.2d 758; 2002 Mass. LEXIS 203* September 10, 2001, Argued April 10, 2002, Decided
[10] *Id.*
[11] *Id*, at 189-190.

It is not clear how much income is being shifted via transfer pricing schemes, PIC's, and other sheltering mechanisms from public documents because businesses are not required to disclose these amounts, nor are they required to disclose all of their affiliates. One measure, albeit crude, is to compare the company's effective tax rate with the statutory tax rate. A significant difference between the two rates is often indicative that income is being sheltered. A study by the Citizens for Tax Justice reveals that 252 large, publicly traded companies state corporate income taxes were 2.6 percent of their domestic (U.S. and territories) profits between 2001 and 2003.[12] *The median state corporate income tax rate during that period was nearly 7 percent. Clearly, a significant amount of tax sheltering was occurring in that period.*

S. 2721 and similar bills would encourage ***all*** *multistate businesses to reorganize themselves in a similar fashion to avoid state tax liability in states where they earn income. Indeed, they would have a fiduciary responsibility to their shareholders to reduce their state business activity tax liabilities through these types of reorganizations.*

Question 6. Under your logic then, is the economic nexus standard an alternative method of attacking abusive tax shelters?

Answer to Question 6. The purposes of the economic nexus standard are to:

1) *Assure that all businesses competing in a state are competing on a "level playing field" with respect to state income taxation.*
2) *Assure that income is reported properly and fairly to the state where the income is earned.*

It should be remembered that states, in pursuit of basic tax fairness, adopted economic presence standards decades ago—long before the current growth in the use of abusive tax shelters. However, by helping achieve the larger tax policy purposes of fairness and integrity in taxation, the economic presence standard also prevents or discourages abusive state tax shelters – shelters that shift income away from where the income was earned.

In contemporary times, imposing a physical presence standard would seriously hinder states in correcting abusive shelters. For example, S. 2721, Section 3 (2), would allow a company to make significant sales into a state and not create nexus for itself it if it used an in-state sales or marketing company which did similar work for at least one other business entity. It would be fairly simple for the large selling company to reorganize itself into two or more business entities and use the in-state agent to make sales and/or perform warranty work. If the in-state marketing firm were an affiliate of the out-of-state firm, it would be possible to shift a great deal of income out of the state into which sales are made by sophisticated transfer pricing. Under the factor presence standard, the out-of-state firm would have nexus in the state into which it is selling its products, if the level of sales exceeded the threshold, regardless of whether it used an in-state sale, marketing service, or other type of service. If S. 2721 were to become law, a state would be prohibited from asserting nexus over the company selling into the state if it used such an arrangement.

[12] Robert S. McIntyre and T. D. Coo Nguyen State ***Corporate Income Taxes 2001-2003***, Citizens for Tax Justice, February 2005, p.19

In short, the factor presence nexus standard establishes a "bright line" test as to whether a state has taxing jurisdiction over a company doing business in the state, can be relatively simple to administer, and can protect smaller businesses from complying with numerous state tax systems if it does not meet the factor threshold levels. Further, this nexus standard makes certain types of tax sheltering schemes more difficult to implement. It would be very detrimental for the federal government to restrict the state from using factor presence standard, or other types of economic nexus standards to combat abusive tax shelters.

Question 7. If economic nexus were the law, what compliance burden would befall a small business using the Internet to sell its products in several states?

Answer to Question 7. Small businesses would be protected from income taxes in states where they do insignificant business because the threshold levels for the apportionment factors in the standard are sufficiently high to exclude most of these types of firms in most states. For example, under the Multistate Tax Commission's Factor Presence Nexus Standard, a business not domiciled in a state, would have nexus in a state if its sales that state were $500,000 or less; or, if its property in a state were less than $50,000; or its payroll in a state were less than $50,000. The business would have nexus in a state if the level of sales; or property; or payroll were less than the threshold but the proportion of its sales; or property; or payroll were greater 25 percent. The threshold limits would be adjusted by changes in the Bureau of Labor Statistic's Consumer Price Index to protect the real value of the thresholds. The threshold levels protect businesses with low levels of business activity in a state from a state's business activity tax. Currently, seventeen (17) states have lower business activity tax rates for businesses with no property in a state and less than $100,000 in sales.[13]

Question 8. The Supreme Court in the Quill case said that, absent legislation by Congress, the Commerce Clause imposed a physical presence nexus standard for sales and use tax collection. You assert in your testimony that an economic nexus standard for business activity taxes is consistent with existing Constitutional standards. What is the legal basis for different nexus standards based on type of tax?

Answer to Question 8. The legal basis for different nexus standard based on type of tax is contained in the answer to Question 1.The Supreme Court in Quill also made clear that it had never required physical presence nexus for any tax other than use tax collection. Furthermore, the Court stated that it might not have required physical presence even for use tax collection if it had not already decided the Bellas Hess case twenty-five years previously. In reaffirming Bellas Hess, the Court was primarily motivated by stare decisis concerns – i.e., a concern that the mail-order industry had developed partly in reliance on the Bellas Hess rule. There are no similar stare decisis concerns for business activity taxes, because, unlike the Bellas Hess decision, the Court's income tax cases have long recognized economic presence as establishing nexus under the Due Process Clause. Furthermore, in the Burger King case – a non-tax case decided under the Due Process Clause, - the Court has recognized that "it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State

[13] Research Institute of America, ***State Tax Handbook, 2006***, pp. 56-58.

in which business is conducted." In finding personal jurisdiction based upon such contacts, the Court stated that the "courts must not be blind to what all others can see and understand." National Bellas Hess and Quill were departures from a long line of Supreme Court precedent finding nexus based on economic presence alone and as such, the Court was careful to limit their scope to use taxes.

Example 1 Transfer Pricing and Royalty Payments

	State A Supplier Subsidiary	New York Grocer Subsidiary	Total	State A Supplier Subsidiary	New York Grocer Subsidiary	Total
Sales of Goods	$20,000,000	$26,000,000		$20,740,000	$26,000,000	
Royalty Income	0			260,000		
Expenses						
Cost of Goods Sold	15,000,000	20,000,000		15,000,000	20,740,000	
Wages	2,000,000	3,000,000		2,000,000	3,000,000	
Rent	1,200,000	2,000,000		1,200,000	2,000,000	
Royalty		0			260,000	
Total Expenses	18,200,000	25,000,000		18,200,000	26,000,000	
Net Income	1,800,000	1,000,000	2,800,000	2,800,000	0	2,800,000
Tax Rate	0	7.5%		0	7.5%	
Tax	0	75,000	75,000		0	

Example 2 New York State Grocer Subsidiary as Agent For Suppliers 1 and 2, Transfer Pricing and Royalty Payments

	State A Supplier Subsidiary	New York Grocer Subsidiary	Total	State A Supplier 1 Subsidiary	State A Supplier 2 Subsidiary	New York Grocer Subsidiary	Total
Sales of Goods	$20,000,000	$26,000,000		$10,370,000	$10,370,000	$26,000,000	
Royalty Income	0			130,000	130,000		
Expenses							
Cost of Goods Sold	15,000,000	20,000,000		7,500,000	7,500,000	20,740,000	
Wages	2,000,000	3,000,000		1,000,000	1,000,000	3,000,000	
Rent	1,200,000	2,000,000		600,000	600,000	2,000,000	
Royalty		0				260,000	
Total Expenses	18,200,000	25,000,000		9,100,000	9,100,000	26,000,000	
Net Income	1,800,000	1,000,000	2,800,000	1,400,000	1,400,000	0	2,800,000
Tax Rate	0	7.5%			0	7.5%	
Tax Rate	0	75,000	75,000			0	

Statement of Sen. Chuck Grassley

Revenue Raisers Related to Offshore Schemes

Delivered Tuesday, March 20, 2007

Mr. President, I'd like to discuss one of the sources of revenue that the Chairman of the Budget Committee claims will help offset the five-year $916 billion cost of extending existing tax policy: shutting down offshore tax havens.

I have been aggressive in combating abusive tax shelters, offshore or otherwise. As Chairman of the Finance Committee, I worked hard to shut down offshore tax evasion. The 2004 JOBS bill shut down the tax benefits for companies that enter into corporate inversion transactions and abusive domestic and cross-border leasing transactions. The JOBS bill also contained a package of 21 anti-tax shelter provisions.

As Ranking Member of the Finance Committee, I saw to it that the minimum wage/small business tax relief package also contained anti-tax loophole provisions, including shutting off tax benefits for corporations that inverted after Senator Baucus and I issued a public warning that legislation would stop these deals, shutting off tax benefits from abusive foreign leasing transactions that weren't caught by the JOBS bill, and doubling penalties and interest for offshore financial arrangements. But the Democratic Chairman of the Ways and Means committee doesn't appear to be supportive of these provisions, even though he voted for many of them in the public JOBS conference in 2004.

So having studied these issues and legislated in this area, I consider my views on tax policy directed at tax shelters and tax havens to be credible. From what I can tell, the Chairman of the Budget committee views the problem of offshore tax havens in two categories: (1) the ability of U.S. multinationals to shift income to these tax havens; and (2) tax evasion by U.S. individuals who hide assets and income in tax havens.

We have seen Democratic senators, including the Chairman of the Budget Committee, hold up a picture of the Ugland House, a law firm's office building in the Cayman Islands, as home to 12,748 corporations. I'd like to give senators some background on where that picture comes from, and what issue it is aimed at.

That picture comes from an article published in Bloomberg Markets in August 2004, titled "The $150 Billion Shell Game". The article focused on the ability of U.S. multinationals to shift income to low-tax jurisdictions through transfer pricing. Transfer pricing is the term for how affiliated corporations set the prices for transactions between them. Transfer pricing is important, because it determines how much profit is subject to tax in the different jurisdictions involved in related party transactions. The $150 billion figure is an academic's estimate of the annual amount of profit that corporations shift outside the U.S. with improper transfer pricing.

So this article is aimed at U.S. corporations who artificially shift their income to low tax jurisdictions through improper transfer pricing practices. To illustrate this point, I've reproduced a few quotes from the article. The first one says: "Under U.S. law, U.S. companies can use Cayman subsidiaries and transfer pricing rules to shift sales and profits from other countries, thus reducing their overall tax burden." The second one the author attributes to Senator Dorgan: "A practice called transfer pricing may be the key to how U.S. corporations avoid taxes in the U.S. and other countries."

One of the Democrats' revenue raisers that is still on the shelf purports to target this transfer pricing problem. But you wouldn't know it by looking at the language of the proposal, because it doesn't make any changes to our transfer pricing rules. Instead, the proposal would eliminate deferral for income of any US multinational's foreign subsidiaries incorporated in certain black-listed jurisdictions. It's called the tax haven CFC proposal.

Part of our tax code since 1918, deferral means that US multinationals do not pay tax on the active income of their foreign subsidiaries until that income is repatriated to the US. Passive income is subject to tax on a current basis. Deferral only applies to active income.

I agree with the premise of this proposal that U.S. multinationals should pay their fair share of U.S. taxes. U.S. multinationals that use improper transfer pricing do so to obtain the benefit of deferral on profits that, economically, should be subject to tax in the U.S. on a current basis. Here is my quote from this Bloomberg article: "We have to get on top of corporate accounting and manipulation of corporate books for the sole purpose of reducing taxes."

So my view is that stronger transfer pricing rules and stronger enforcement of those rules is the right way to target this problem in our current international tax system. The IRS is taking steps to tighten our transfer pricing rules. In 2005, the IRS proposed regulations that would overhaul the rules for so-called cost sharing arrangements. These are arrangements by which U.S. multinationals are able to transfer intangible property to subsidiaries in low-tax jurisdictions. Based on the volume of complaining I've seen lobbyists level at Treasury and the IRS, the proposed IRS regulations would go a long way to prevent artificial income shifting. I hope to see these regulations finalized soon.

Others have a different view. They would eliminate deferral all together. Another quote in the Bloomberg article succinctly states this view. This is a quote from Jason Furman, former aide to Senator Kerry: "American companies should pay taxes on their profits in the same way whether they earn them in Bangalore or Buffalo."

So that's where these proposals to eliminate or curtail deferral on a piecemeal basis are headed – the complete elimination of deferral for U.S. multinationals. Without a significant corporate tax rate reduction, eliminating deferral would have the effect of exporting our high tax rates and putting US multinationals at a competitive disadvantage in the global marketplace. The Senate is on record as wanting to protect the competitiveness of U.S. businesses in the global marketplace. The Senate passed the American Jobs Creation Act in 2004, which contained several international simplification provisions, with the vote of 69 Senators, including 24 Democrats. The Senate version of the JOBS bill, which also contained these provisions, received the vote of 92 Senators, including 44 Democrats.

There has been a longstanding debate about whether our international tax system should be fundamentally changed. Some advocate for taxing all foreign income on a current basis. Others argue for completely exempting active foreign income under a territorial system, as many of our trading partners do. If we want to have that debate, then it's a fair debate to have. But piecemeal cutbacks on deferral for active foreign income would do nothing but complicate the tax code and create opportunities for tax planning around those cutbacks.

The other offshore issue identified by the Chairman of the Budget committee is U.S. tax evasion by individual taxpayers who hide their assets and income in foreign bank accounts and foreign corporations. Since 1913, our tax code has subjected U.S. citizens to

tax on their worldwide income. No matter what the internet purveyors of tax evasion say, this principle cannot be avoided by putting passive assets and income into a foreign corporation. The tax code has rules to prevent this. Taxpayers that willingly violate these rules are guilty of tax fraud, in many cases, criminal tax fraud.

So the problem of offshore tax evasion isn't that our laws permit it. The problem is that there are some taxpayers who are intent on cheating and hiding their income from the IRS. The IRS has been successful in catching many of these tax cheats, but more can be done.

The IRS has difficulty detecting tax evasion and obtaining the information necessary to enforce our laws. One important tool for the IRS is information exchange with other jurisdictions. Our double tax treaties contain an article on information exchange designed to help the IRS obtain quality information to enforce our tax laws. In addition, administrations past and present have entered into over 20 tax information exchange agreements with jurisdictions that are often referred to as tax havens. Sensible solutions to this problem should aim to improve on our tax information exchange network, and not put it at risk.

Underreported income is the largest piece of the tax gap. We should keep in mind that hiding assets and income from the IRS isn't just an offshore tax haven problem. It may also be an on-shore problem. A recent article in the USA Today noted that there is "a thriving mini-industry that has capitalized on real or perceived gaps in domestic incorporation laws and virtually non-existent government oversight to promote some U.S. states as secrecy rivals of offshore havens."

The picture of the Ugland House in the Cayman Islands makes for good grandstanding, but there are also office buildings in some states that are listed as addresses for thousands of companies who are incorporated in those states for similar reasons as those incorporated in the Caymans – secrecy of ownership and a permissive regulatory environment. Whatever additional solutions the Finance Committee comes up with to shine sunlight on tax evaders will need to consider both offshore and onshore evasion.

To conclude, I want to emphasize that I'm all for shutting off inappropriate tax benefits from offshore arrangements. The Chairman has said that he thinks we could get $100 billion a year from this source. I haven't seen any proposals scored by the Joint

Committee on Taxation that come close to bringing in this kind of money. The last score I've seen for the tax haven CFC proposal is $7.7 billion over 5 years. Senators Levin, Coleman, and Obama have recently introduced a bill that contains several proposals aimed at offshore tax havens, but I haven't seen a JCT score yet.

So once again, it will be the Finance Committee's responsibility to come up with real, sensible, effective proposals to combat offshore and onshore tax evasion, which I am glad to do. But the likelihood that they will be scored by JCT to bring in the kind of money assumed in this budget resolution is remote, at best.

ECONOMIC ANALYSIS

A Challenge to Conventional International Tax Wisdom

By Martin A. Sullivan — martysullivan@comcast.net

International tax policy is not written in black or white but rather in shades of gray. The grayness results because there is no clear answer to the question, should the foreign income of U.S. multinationals be taxed at the U.S. rate or the foreign rate? Economists want a level playing field, but for international tax policy, they don't know which level to choose. The usual guiding principles of economics provide little guidance.

As a result, U.S. international tax policy is a jumble of rules with a variety of political and economic justifications. It is often described as a "compromise" that strikes a "balance." We lean toward tightening foreign tax rules and putting foreign income on equal footing with U.S. income when we think foreign investment hurts the U.S. economy. Then we lean toward relaxing the rules and giving foreign income favorable treatment if we believe foreign investment promotes U.S. interests.

U.S. international tax policy is a jumble of rules with a variety of political and economic justifications.

When does foreign investment promote U.S. interests? The answer to that question — and therefore the answer to the question of where to strike the right balance in international taxation — does not depend on economic principles but rather on economic facts.[1] In this article, the facts come from U.S. Commerce Department data on affiliates of U.S.-based multinational corporations. Tables 1 (next page) and 2 (p. 953) summarize the data for 1983 and 2004.

The Situation in 1962

Congress devised the basic structure of U.S. antideferral rules in 1962. It was a "practical legislative solution"[2] to address particular facts and circumstances that prevailed at the time. Figure 1 (p. 954) provides a simplified view of the world in 1962. It highlights three features. First, U.S. multinationals did not face a lot of competition from other multinationals.[3] Second, there was little U.S. foreign direct investment in low-tax countries.[4] Third, there was rapid growth in the use of earnings stripping transactions in which multinationals artificially shifted income from high-tax affiliates to tax havens.[5]

The Commerce Department provides data only back to 1983, but those early figures show that — even two decades after the enactment of subpart F — direct investment in low-tax countries accounted for only a small amount of foreign direct investment in tangible assets by U.S.-based multinationals. Figure 2 (p. 955) shows the percentage of physical capital held by U.S. multinational corporations in low-tax countries in 1983 and 2004. In 2004 the amount of property, plant, and equipment in countries with effective tax rates more than 20 percentage points below the U.S. statutory rate was 12.8 percent. In 1983 that figure was 7.8 percent. It does not seem unreasonable to infer that the percentage was even lower in 1962.[6]

The Kennedy administration wanted a general antideferral regime. It proposed repealing deferral, except in developing nations (which at the time included countries like Ireland and Singapore). Congress, however, did not agree to blanket repeal. Eventually a compromise was struck in which

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[1]Glen Hubbard (2006) makes a similar point:

> One implication of the accumulation of research is that there is no simple general abstract principle that applies to all international tax policy issues. The best policy in each case depends on the facts of the matter and how the system really works.

[2]Paul Oosterhuis (2006b). In his tribute to Larry Woodworth, former chief of staff of the Joint Committee on Taxation, (Footnote continued in next column.) Oosterhuis highlighted the "practical wisdom" of the subpart F rules, which Woodworth played a major role in devising.

[3]According to the Council of Economic Advisers' *Economic Report of the President, 2003*: "In 1960, 18 of the world's 20 largest companies (ranked by sales) were located in the United States, but by the mid-1990s that number had fallen to 8."

[4]Oosterhuis (2006b) wrote that, at the time, lowering a U.S. corporation's effective tax rate below the U.S. rate "required locating profitable manufacturing facilities in low-taxed jurisdictions, *which for non-tax reasons was often more difficult to do*" (emphasis added). Treasury (2000, p. 21): "This legislative history indicates that Congress (and the Administration) assumed that U.S.-owned foreign corporations were conducting active businesses only in countries in which the tax rate was equivalent to that of the United States."

[5]In 1960 according to the 2000 Treasury Department report, "use of tax haven corporations to obtain a tax advantage for income otherwise earned in a high-tax foreign country was a new and rapidly growing phenomenon."

[6]And whatever little there was, it was not a major concern because the Kennedy administration wanted to encourage U.S. investment in developing countries as a form of foreign aid. Many developing countries no doubt were low-tax countries. In the 2006 Woodworth lecture, Oosterhuis (2006b) said that when the rules favoring developing economies were formulated (in force from 1962 through 1976), "only 21 countries outside the former communist bloc were excluded from being defined as less developed countries. Singapore and Ireland, for example, were both eligible for less-developed country designation."

Table 1. Facts About Affiliates of U.S. Multinational Corporations, 1983
(Dollar amounts in millions. Employees in thousands.)

	Gross Receipts	Net Property, Plant, and Equipment	Employees	Before-Tax Profits	Effective Tax Rate	Return on Sales
All countries	$719,245	$159,137	4,853.6	$56,904	52.9%	8%
Group A. Countries with effective rates more than 20 percentage points below U.S. rate						
Netherlands Antilles	7,446	342	2.7	1,437	15.4	19
Bermuda	18,462	136	3.3	1,196	3.0	6
Switzerland	32,696	1,049	38.4	1,135	20.5	3
Ireland	4,965	1,399	33.2	950	3.3	19
Singapore	12,510	1,297	47.4	726	15.0	6
Hong Kong	8,119	1,577	39.9	653	11.2	8
Other "20 percent countries"	23,975	5,321	216	1,898	17.1	8
Group B. Countries with effective rates between 15 percentage points and 20 percentage points below U.S. rate						
Netherlands	26,588	4,058	98.6	1,484	32.7	6
Malaysia	4,885	1,813	60.6	630	33.8	13
Other "15 percent countries"	1,992	252	15	109	33.9	5
Group C. Countries with effective rates less than 15 percentage points below U.S. rate						
United Kingdom	107,674	28,052	678.4	9,533	60.8	9
Canada	121,805	33,018	824.2	8,556	43.2	7
Indonesia	11,270	4,519	44.7	4,164	57.2	37
Norway	8,802	5,619	15.9	3,000	73.2	34
Germany	67,242	11,592	490.5	2,816	46.7	4
Libya	3,765	561	3.9	2,097	93.4	56
United Arab Emirates	3,787	977	5.6	1,910	84.7	50
Nigeria	3,934	1,038	7.6	1,777	80.0	45
Japan	25,387	2,845	85.1	1,479	51.7	6
Australia	25,975	6,698	183.5	1,473	67.1	6
France	41,109	4,937	278.1	1,332	55.3	3
Italy	24,872	2,576	168.6	1,169	41.7	5
Brazil	20,681	7,425	326.2	982	75.4	5
Belgium	19,922	2,444	118.8	680	39.0	3
South Africa	7,945	1,164	80.8	650	41.8	8
Saudi Arabia	9,775	663	89.1	544	84.7	6
All other countries	73,662	27,765	898	4,524	71.8	6

Source: U.S. Department of Commerce. Please see Appendix for details.

deferral was limited only for passive income and income from earnings-stripping transactions. Active business income from low-tax countries could still be deferred.[7]

As a result of the complex compromise that brought subpart F into law, two generations of tax lawyers grew up with the mindset that active income from bricks-and-mortar investment was good and should enjoy deferral, and mobile income deflected from high-tax countries to tax havens in abusive "mere paper" transactions was bad and should be denied deferral. But was this new gospel

[7]Treasury (2000, pp. 18-19). The Treasury Department was concerned about two situations:

> The first situation arose when taxpayers were conducting business operations in a foreign jurisdiction with tax rates that were lower than those in the United States. The second situation arose when taxpayers were conducting business operations in a foreign jurisdiction with tax rates that were comparable to or greater than those in the United States but were able to lower their foreign tax burden artificially through an arrangement involving a tax haven corporation. Subpart F was designed to address the second situation. The Kennedy Administration did not consider the first situation to be a concern because, in 1962, tax rates in most developed countries that were not used for tax haven operations were substantially comparable to the U.S. tax rate, and the Kennedy Administration specifically intended to encourage investment in lesser developed countries that were not used for tax haven operations.

(Footnote continued in next column.)

Table 2. Facts About Affiliates of U.S. Multinational Corporations, 2004
(Dollar amounts in millions. Employees in thousands.)

	Gross Receipts	Net Property, Plant, and Equipment	Employees	Before-Tax Profits	Effective Tax Rate	Return on Sales
All countries	$3,493,764	$768,231	8,617.2	$253,265	28.2%	7.2%
Group A. Countries with effective rates more than 20 percentage points below U.S. rate						
Ireland	135,752	13,333	82.8	20,087	8.3	14.8
Bermuda	66,775	4,526	2.3	9,957	5.8	14.9
Switzerland	148,504	6,595	67.3	9,161	12.2	6.2
Singapore	129,055	10,161	110.7	6,269	11.1	4.9
Belgium	78,206	12,226	120.0	6,080	14.3	7.8
China	64,563	12,455	407.9	5,735	15.0	8.9
Hong Kong	67,740	5,447	117.8	4,593	15.1	6.8
Cayman Islands	32,075	3,276	8.3	3,648	0.8	11.4
Other "20 percent countries"	107,838	30,297	350	10,290	14.4	9.5
Group B. Countries with effective rates between 15 percentage points and 20 percentage points below U.S. rate						
Australia	93,789	34,505	271.9	8,054	20.4	8.6
Sweden	57,261	17,943	101.2	3,357	23.8	5.9
Malaysia	35,312	5,856	97.5	3,252	20.2	9.2
Spain	73,252	13,081	197.2	3,171	23.4	4.3
Other "15 percent countries"	61,282	25,897	200	7,353	23.8	12.0
Group C. Countries with effective rates less than 15 percentage points below U.S. rate						
Canada	437,649	123,440	1,065.1	26,219	31.5	6.0
United Kingdom	461,918	122,432	1,166.3	21,900	32.7	4.7
Japan	186,985	24,155	227.6	16,440	37.4	8.8
Netherlands	177,233	20,537	175.1	8,644	30.9	4.9
France	171,415	32,669	562.8	8,381	28.4	4.9
Norway	27,895	17,217	33.4	7,663	69.8	27.5
Mexico	117,183	25,682	785.2	6,904	33.9	5.9
Other African Countries	21,786	19,547	68.1	6,599	39.3	30.3
Germany	264,635	49,420	601.7	5,559	41.1	2.1
Indonesia	12,098	11,103	59.7	4,372	43.6	36.1
Italy	101,081	17,238	238.5	4,180	53.3	4.1
Brazil	73,787	20,586	345.8	4,149	34.0	5.6
Nigeria	8,554	8,267	7.3	3,953	77.9	46.2
Thailand	28,453	7,075	114.4	3,016	25.7	10.6
All other countries	251,688	73,265	1,031	24,279	38.5	9.6

Source: Commerce Department. *See* Appendix for details.

based on an enduring principle, or was it based on the situation as it existed in 1962?

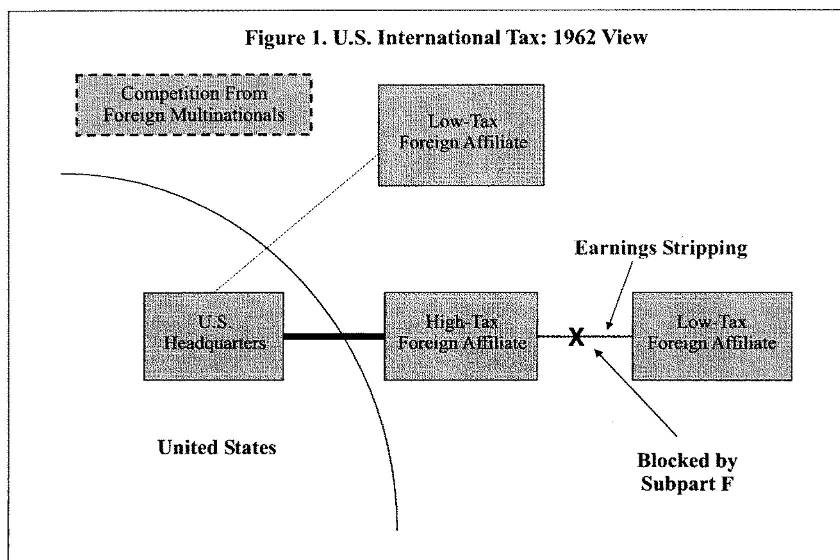
From an economic perspective, there is nothing intrinsically meritorious about active investment in low-tax countries that suggests it should be given preferential treatment under U.S. tax law. Is it too far-fetched to believe that preferential treatment was tolerated because it was not a major issue under the existing circumstances when the subpart F rules were developed? First, for nontax reasons, at that time there was simply a lot less direct investment in low-tax economies than there is now. Second, it was the Kennedy administration's intention, as a matter of foreign policy, to allow the deferral of income from affiliates in developing countries, many of whom would have had low tax rates. At that time, the looming economic concern of international tax policy was that high-tax industrialized countries would siphon U.S. investment when they were effectively transformed into low-tax countries through the use of earnings stripping transactions.

The Situation Now

As we all know, the facts and circumstances have changed since 1962. Figure 3 (p. 956) provides a simplified view of the major developments.

First, we now have the phenomenon of "runaway headquarters." It was inconceivable in 1962 that U.S. corporations would move their operation

Figure 1. U.S. International Tax: 1962 View



centers to foreign jurisdictions to reduce taxes. That is no longer the case. Corporations headquartered in the United States can and do relocate to other industrialized countries.

This migration can manifest itself in a variety of ways. For example, when a U.S. company merges with a foreign company, the new entity may locate its headquarters abroad because of restrictive U.S. international tax rules. Or, if U.S. tax rules are tough, start-up companies are more likely to establish their headquarters offshore. Perhaps most worrisome are the less visible and more subtle possibilities. Foreign-based multinationals may be able to gobble up more of the world's productive capacity than U.S. corporations burdened with U.S. international tax rules. In that case, the corporate headquarters don't move, but, in effect, the subsidiaries underneath them do. The potentially detrimental effect is the same: fewer headquarters jobs for U.S. residents.

The second major change since 1962 is that interaffiliate cross-border transactions with real business purposes are much more common. As the world gets smaller and communications and transportation costs drop, it is routine for sales and services affiliates to be centralized along multinational — rather than national — lines to achieve economies of scale.[8] Income from those transactions can easily get caught in the web of subpart F base company rules.

Those developments provide justification to shift the balance of U.S. international tax policy toward more favorable treatment of foreign investment. Conservative think tanks cite those changes as a justification for moving toward a territorial tax system in which most foreign-source income would be exempt from U.S. tax.[9] Multinational corporations cite those changes as a justification for relaxing U.S. international tax rules (but not necessarily for switching to a territorial system).[10]

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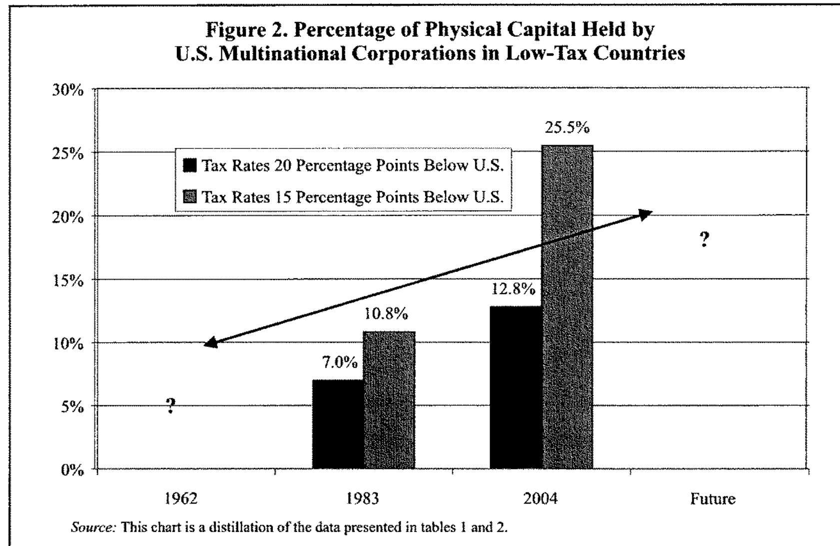
[8]Oosterhuis (2006a), in his June 22 Ways and Means testimony, described the situation this way:

> As business models have adapted to the globalized economy and manufacturing and marketing of products is conducted across multiple national boundaries for legitimate business reasons, the mechanical nature of the rules results in many transactions creating subpart F income even though they involve very real and substantial business operations.

[9]For example, Daniel Mitchell (2003) of the Heritage Foundation favors a territorial system:

(Footnote continued on next page.)

Figure 2. Percentage of Physical Capital Held by U.S. Multinational Corporations in Low-Tax Countries



Source: This chart is a distillation of the data presented in tables 1 and 2.

On top of the changes in the nontax characteristics of multinational business, a major (and largely unintended) shift in the balance of international tax policy occurred in the late 1990s when the Treasury Department announced the check-the-box entity classification rules. The rules allowed U.S. corporations to engage in earnings stripping transactions and circumvent U.S. antideferral rules.

The final development I will highlight here has to do with foreign direct investment in low-tax countries. There is more of it now than in 1962. And, as suggested by the arrow in Figure 2, there could be more of it in the future.[11]

The Problems With Low-Tax Investment

Should the U.S. be concerned about the rise in foreign direct investment in low-tax countries?

To answer that question, I will draw the oft-made distinction between two categories of foreign direct investment. The first type establishes "export platforms" that provide market access for goods and services from the United States. This type of investment is more likely to help create jobs in the United States. Economists say this type of foreign investment *complements* domestic investment. The second

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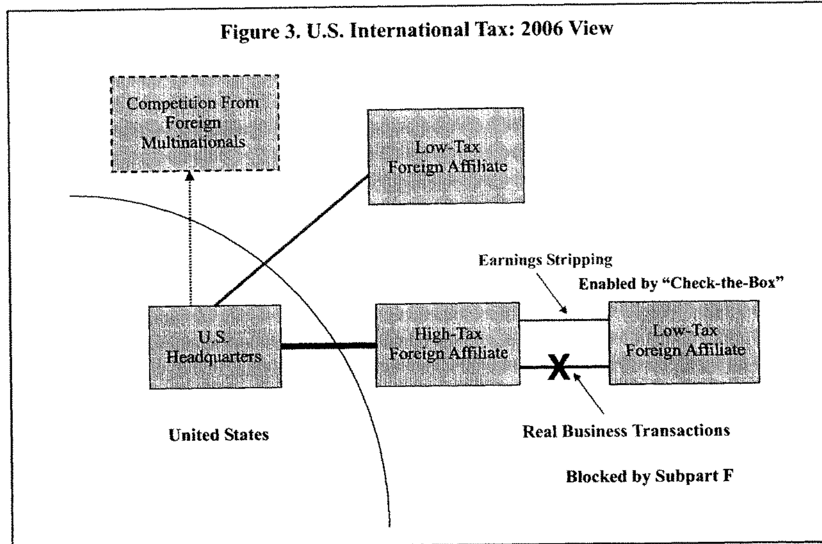
Ideally, lawmakers should engage in wholesale change, junking America's "worldwide" tax system (whereby companies are taxed on income earned in other nations) and replacing it with a "territorial" tax system (the common-sense practice of taxing only income earned inside national borders). This reform would allow U.S.-based companies to compete on a level playing field with foreign competitors.

[10]For example, Judy Scarabello (2004) of the National Foreign Trade Council stated that:

> moving to a territorial tax system alone would not cure the problems inherent in the U.S. international tax system and would put U.S. companies at a significant disadvantage in the global market. The United States should instead concentrate legislative efforts on improving current international tax rules.

[11]Craig Barrett (2006), chairman of the board, Intel Corp.: Many countries compete intensely to attract Intel's facilities, although *this has also changed in recent years*. More nations very intent on attracting high-tech state-of-the-art factories, such as Intel's, *now also have the requisite infrastructure and well-trained workforce they lacked in years past*. Many countries offer very significant incentive packages and have highly favorable tax systems." (Emphasis added.)

Figure 3. U.S. International Tax: 2006 View



type of foreign investment builds production facilities that provide goods to the U.S. economy and compete with U.S. exports in foreign markets. Economists say this type of investment *substitutes* for domestic investment.

It is interesting to note that the first type — investment for market access — does not give a multinational much flexibility regarding location. For example, an investment in marketing and distribution to help sell products in France must, for the most part, be made in France. In contrast, investment for production is mobile. With low tariffs and transportation costs, corporations have considerable leeway in choosing the location of their production facilities.

The differences in the degree of mobility of those two types of investment provide a clue of how they might be taxed. We know from economic theory and casual observation that countries reduce tax rates to attract mobile production. However, there is less need to engage in tax competition by host countries when foreign investment relates to access to domestic markets. If that is true, foreign investment that tends to help the United States would generally be found in high-tax countries, and investment that tends to hurt the United States would be found in low-tax countries.

Is there any evidence to support this theory? Table 3 (next page) provides some. It shows the latest available data on U.S. trade with foreign affiliates of U.S. multinationals. On the top half of the table are the countries that account for the most net imports from foreign affiliates into the United States. On the bottom half are the countries that account for the most net exports from the United States. The countries at the top, those with which the United States has a negative trade balance with foreign affiliates, tend to have lower effective corporate tax rates than those at the bottom. Specifically, the countries where affiliates tend to import more goods into the United States have an average effective tax rate of 21 percent. (If Canada and Mexico — where proximity, rather than tax competition, accounts for imports into the United States — are excluded, the average rate declines to 12 percent.) The countries where foreign affiliates are receiving more exports from the United States have an average effective tax rate of 28 percent.

Ireland is the most prominent example of the link between low tax rates and high imports into the United States. As shown in Table 3, the average

	Table 3. Balance of Trade in Goods of the United States With Foreign Affiliates of U.S. Corporations, 2004 (Dollar amounts in billions)				
		Exports of Goods From United States to Foreign Affiliates	Imports of Goods Shipped by Affiliates to United States	U.S. Trade Balance With Foreign Affiliates	Effective Tax Rate
	All countries	**$184.1**	**$231.5**	**-$47.4**	**28%**
	Top 10 importing into United States	105.4	174.8	-69.4	21
	Top importers, minus Canada and Mexico	17.1	49.1	-32.0	12
	Top 10 exporting from United States	51.4	25.5	25.9	28
	Countries with most net imports from affiliates to the United States				
1	Canada	58.9	84.5	-25.6	32
2	Ireland	2.2	15.5	-13.3	8
3	Mexico	29.5	41.2	-11.7	34
4	Malaysia	1.5	8.5	-7.0	20
5	Hong Kong	2.4	6.5	-4.1	15
6	Sweden	1.4	5.3	-3.9	24
7	Singapore	7.9	9.9	-1.9	11
8	Thailand	0.9	1.7	-0.8	26
9	Cayman Islands	0.2	0.7	-0.5	1
10	Costa Rica	0.4	0.9	-0.5	11
	Countries with most net exports from the United States to affiliates				
1	Japan	9.4	2.6	6.8	37
2	Netherlands	7.8	2.6	5.2	31
3	Belgium	5.1	2.0	3.1	14
4	Australia	4.4	1.7	2.8	20
5	United Kingdom	11.9	9.8	2.1	33
6	Taiwan	3.1	1.2	1.9	25
7	South Korea	1.9	0.3	1.6	27
8	Switzerland	3.4	2.5	0.9	12
9	Brazil	3.1	2.3	0.9	34
10	Philippines	1.3	0.6	0.7	34

Source: Commerce Department. *See* Appendix for details.

effective tax rate on profits in Ireland was 8 percent in 2004. In the same year, Irish affiliates of U.S. multinational corporations received $2.2 billion of exports from the United States while importing $15.5 billion of goods into the United States — a negative $13.3 billion trade balance for the United States with Irish affiliates of U.S. corporations.

Overall, these data suggest that investment in low-tax countries (which tends to increase imports into the United States) is less beneficial to U.S. competitiveness than investment in high-tax countries (which tends to facilitate exports from the United States).

That basic argument grows stronger when one takes transfer pricing into account. As Lee Sheppard has written: "Transfer pricing is not a detail." (See *Tax Notes*, Nov. 21, 2005, p. 1002, *Doc 2005-23402*, or *2005 TNT 224-4*.) Aggressive transfer pricing can turbocharge the incentive effects of low rates. For example, suppose a corporation can shift profits from a country with a 35 percent tax rate to a country with a 15 percent tax rate, so that before-tax profits in the low-tax country double. In that case, the corporation pays 15 cents for each dollar of real profit in the low-tax country. And, by virtue of profit shifting, it reduces tax in the high-tax country by 20 cents. The combination of those two effects results in an effective tax rate of negative 5 percent.

Is there any evidence that aggressive transfer pricing inappropriately shifts profits to tax havens? Figure 4 (p. 959) shows that 30 percent of the before-tax profits of foreign affiliates were located in countries with average effective tax rates 20 percentage points below the U.S. rate. However, only 13 percent of the physical capital, 24 percent of the sales, and 15 percent of the employees of foreign affiliates were located in those countries. These data are not conclusive evidence, but they do suggest

that the level of profit in low-tax countries is not commensurate with real economic activity. Ireland, again, provides a striking example. Its low statutory rate of 12.5 percent seems to be a magnet for profits, as evidenced by the fact that the ratio of profits to sales there is twice the worldwide average.

Time to Reorder Priorities?

Since 1998 the check-the-box rules and the wave of earnings stripping transactions they have enabled have transformed U.S. international taxation. Understandably, because of the sheer magnitude and rapidity of the change they have caused, the check-the-box rules have captured the attention of international tax practitioners.

Whether the ensuing reduction in the tax burden on foreign investment is a positive or negative policy development is often framed as an issue of neutrality. Some say earnings stripping is good because it makes U.S. multinationals more competitive.[12] Some say it is bad because it provides tax incentives to shift investment out of the United States.[13]

In their June testimonies before the House Ways and Means Committee, Paul Oosterhuis and Michael Graetz deepened the debate with additional insights. Oosterhuis argued that U.S. tax rules should be reasonably in line with the rules of other countries that serve as homes to major multinational competitors, and that the type of earnings stripping enabled by the check-the-box rules is "substantially more difficult to accomplish" under the rules in most of those countries than under U.S. rules.[14] Graetz expressed concern that when the United States unilaterally allows earnings stripping by its multinationals, it is inviting foreign countries to enact rules that will allow their companies to strip earnings from the United States.

Without taking away anything from those arguments, I suggest that problems with direct foreign investment in low-tax countries are as large as, if not larger than, the problems arising from earnings stripping from high-tax countries. There are two reasons. First, as already noted, investment in high-tax countries tends to be the type that helps create U.S. jobs, and investment in low-tax countries tends to be the type that reduces U.S. employment.

Second, even if there are no differences in the character (that is, export versus import enhancing) of investment in high- and low-tax countries, there are differences in the magnitude of economic distortions due to the differences in the effective rate of foreign tax on each type of investment. The tax differential between the U.S. rate and the rate in high-tax countries (after earnings stripping) is probably smaller than the differential between the U.S. rate and the rate in low-tax countries (particularly after transfer pricing). There is less economic inefficiency in the first case than in the second.

> ***I suggest that problems with direct foreign investment in low-tax countries are as large as, if not larger than, the problems arising from earnings stripping from high-tax countries.***

For example, suppose an earnings stripping transaction cut the effective rate of tax in Germany in half — say, to 20 percent — while direct investment in a low-tax country like Ireland — turbocharged with aggressive transfer pricing — reduced the effective tax rate to zero. With a combined state and federal rate in the United States close to 40 percent, this would result in a 20 percent differential for investment in Germany and a 40 percent differential for investment in Ireland. If those numbers are in the ballpark, the tax benefits for investing in Ireland should cause greater concern than the tax benefits for investing in Germany.[15]

Therefore, as we think about where to strike the right balance in international tax policy, consideration should be given to the potential inefficiencies resulting from direct active investment in low-tax countries. This is the "challenge to conventional international tax wisdom" in the title to this article.

Policy Implications

What do these concerns about foreign investment in low-tax countries suggest for policy?

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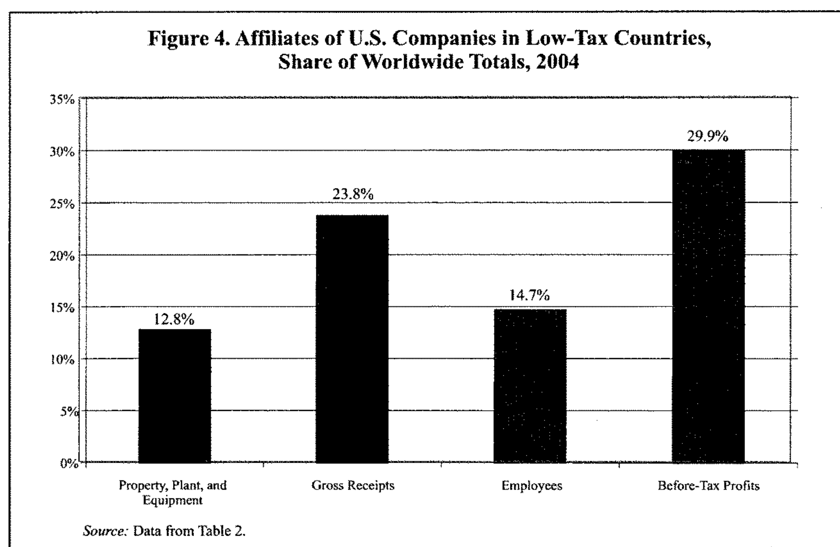
[12]The National Foreign Trade Council report (2001, p. 27) takes this position: "Capital export neutrality is not a persuasive justification for rules that penalize the use of centralized sales and services companies or inter-affiliate debt financing."

[13]Graetz (2006) characterizes this view as follows:

> Analysts who are predominantly concerned with the potential for tax-induced capital flight abroad — those who urge policy based on capital export neutrality — will argue that the U.S. should act unilaterally to shore up the ability of foreign governments to prevent such tax reductions, for example, by tightening our Subpart F rules.

[14]Oosterhuis (2006a) specifically mentions Canada, France, Germany, Japan, and the United Kingdom. Except in the case of Canada, he suggests that "the kinds of earnings stripping transactions that check-the-box planning and newly enacted related party look-through rules permit are substantially more difficult to accomplish."

[15]Those concerns are heightened if one takes into account the economic principle that the inefficiency of uneven taxes varies with the square of the differential. Therefore, in this example, the tax differential between Ireland and the United States, which is twice as large as the tax differential between Germany and the United States, is four times as inefficient.



First, they are another reason for the United States to lower its statutory corporate tax rates. Among its many benefits, a rate cut will reduce the incentive for corporations to shift profits and investment to low-tax jurisdictions. Although there is no political impetus for cutting corporate taxes now, international development will probably necessitate a U.S. rate cut sooner than most politicians realize.[16]

Second, the United States should beef up transfer pricing rules to prevent increasing the incentive effect of already favorable tax rates in production tax havens. Lax transfer pricing rules are an inefficient means of promoting multinational competitiveness.

Third, the United States should consider — in part as a backstop to the transfer pricing rules, and in part to trim the most potent incentives for investment in foreign production — a modest tightening of U.S. tax rules for active income generated in low-tax countries. One possibility would require U.S. companies operating in low-tax countries to pay an additional U.S. tax on current foreign earnings equal to the difference between a minimum rate of, for example, 20 percent or 25 percent, and the effective foreign rate. U.S. companies would still have incentive to invest offshore, but the largest and most harmful incentives to shift income and investment out of the United States would be eliminated. (This type of targeting by tax rate is sometimes called a "low-tax kick-in.")

A final word about context: Politicians trying to strike a populist chord may be tempted to associate the perceived problems of the offshoring of jobs and the decline in U.S. manufacturing jobs to the favorable tax treatment foreign investment receives relative to domestic investment. But that would be like blaming an assistant coach for a team's bad season.

In 2004 foreign affiliates of U.S. multinational corporations employed 8.62 million people. Of that total, 1.27 million were in countries with tax rates 20 percent below the U.S. rate (as can be seen in Table 3). Most of those jobs would be in foreign jurisdictions regardless of the tax rules. Nontax factors (like low labor costs and proximity to raw materials and inexpensive energy) dominate most investment location decisions. And whatever jobs are lost as a

[16] *See* Sullivan (2006).

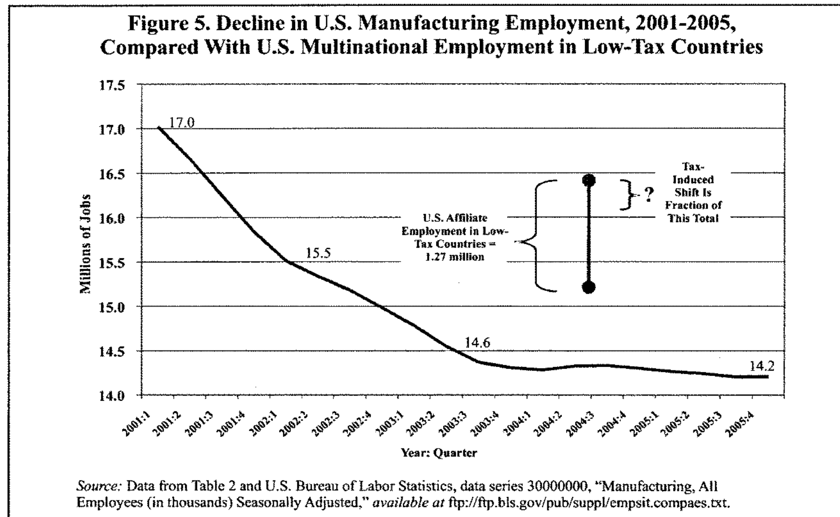


Figure 5. Decline in U.S. Manufacturing Employment, 2001-2005, Compared With U.S. Multinational Employment in Low-Tax Countries

Source: Data from Table 2 and U.S. Bureau of Labor Statistics, data series 30000000, "Manufacturing, All Employees (in thousands) Seasonally Adjusted," *available at* ftp://ftp.bls.gov/pub/suppl/empsit.compaes.txt.

result of the tax benefits of foreign investment in production facilities may be indirectly offset, at least in part, by increases in jobs for the provision of headquarters services.

I do not know the number of jobs lost because of the favorable tax treatment of foreign investment. It may be 0, 10,000, or 100,000. But in any case, I know that it is a minute part of the national employment picture. Figure 5 shows, for example, that any effect of international tax rules on domestic employment is small compared with the 2.8 million manufacturing jobs lost between 2001 and 2005.

In summary, given the potent tax advantages sometimes available to investment in foreign production, we should be concerned about the potential for tax policy contributing to the phenomenon of "runaway plants." But the magnitude of the problem is relatively small, and concerns about it should be balanced against concerns about runaway headquarters. Given the current facts and circumstances, when policymakers are choosing how to strike the balance of international tax policy, if they are going to curtail foreign tax benefits at all, they may want to give priority to the foreign tax rules that have the most potential to hurt U.S. employment.

Appendix: Notes on the Data

Most data in this article are from the Bureau of Economic Analysis (BEA) of the Commerce Department, International Economic Accounts, U.S. Direct Investment Abroad: Financial and Operating Data, Additional Data for U.S. Parent Companies and Foreign Affiliates, Revised 1983 Estimates and Preliminary 2004 Estimates (available online at http://www.bea.gov/bea/ai/iidguide.htm#link12b). All data presented here are for majority-owned, nonbank foreign affiliates of nonbank U.S. parents.

In tables 1 and 2, pretax income is constructed by adding net income and foreign income taxes and then subtracting income from equity investments. The effective tax rate is foreign income taxes divided by pretax income. Gross receipts is labeled "Total Income" in the BEA tables.

In tables 1 and 2, the data are sorted into three categories: countries with average corporate tax rates more than 20 percent below the U.S. rate; countries with average tax rates between 20 percent and 15 percent below the U.S. rate; and countries with average tax rates less than 15 percent below the U.S. rate.

The U.S. rate is the combined federal and average effective state corporate tax rates. For 1983 it is

assumed to be 49.7 percent, which equals the top federal statutory rate of 46 percent plus an average effective rate of 3.7 percent (equal to 1.0 minus 0.46, multiplied by a pre-federal-tax average state tax rate of 6.9 percent). The combined federal and average effective state corporate tax rate for 2004 is assumed to be 39.5 percent, which equals the top federal statutory rate of 46 percent plus an average effective rate of 4.9 percent (equal to 1.0 minus 0.35, multiplied by a pre-federal-tax average state tax rate of 6.9 percent). See the data appendix of Sullivan (2006) for more details.

For 1983 Group A countries have effective tax rates below 29.7 percent. Group B countries have effective tax rates between 29.7 and 34.7 percent. Group C countries have rates above 34.7 percent. Only countries for which total pretax profit of U.S. affiliates exceeds $500 million are reported separately in Table 1. Countries with effective tax rates below 29.7 percent not listed separately in Table 1 are Argentina, Bahamas, Cayman Islands, Denmark, Jamaica, Liberia, Panama, South Korea, and Taiwan.

For 2004 Group A countries have effective tax rates below 19.5 percent. Group B countries have effective tax rates between 19.5 percent and 24.5 percent. Group C countries have rates above 24.5 percent. Only countries for which total pretax profit of U.S. affiliates exceeds $500 million are reported separately in Table 2. Countries with effective tax rates below 19.5 percent not listed separately in Table 2 are Barbados, Chile, Costa Rica, the Dominican Republic, Israel, Luxembourg, Poland, Portugal, and Venezuela.

Data for Table 1 are from BEA Table 24, "Net Property, Plant, and Equipment of Affiliates, Country by Industry"; BEA Table 28, "Income Statement of Affiliates, Industry by Account"; and BEA Table 46, "Employment of Affiliates, Country by Industry."

Data for Table 2 are from BEA Table III.E 1, "Income Statement of Affiliates, Country by Account"; BEA Table III.B 7, "Net Property, Plant, and Equipment of Affiliates, Country by Industry"; and BEA Table III.H 1, "Employment and Compensation of Employees of Affiliates, Country by Type."

Data for Table 3 are directly from tables 1 and 2 with the addition of imports ("Total imports of goods shipped by affiliates") and exports ("Total exports of goods shipped to affiliates") from BEA 2004 Table III.I 1, "U.S. Trade in Goods With Affiliates, by Country of Affiliate."

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AeA (AMERICAN ELECTRONICS ASSOCIATION)
INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA
INFORMATION TECHNOLOGY INDUSTRY COUNCIL
SOFTWARE AND INFORMATION INDUSTRY ASSOCIATION
SOFTWARE FINANCE AND TAX EXECUTIVES COUNCIL

May 4, 2006

Hon. Charles E. Schumer
United States Senate
Washington, DC 20510-3202

Hon. Michael D. Crapo
United States Senate
Washington, DC 20510-1204

Re: **Business Activity Tax Simplification Legislation**

Dear Senators Crapo and Schumer:

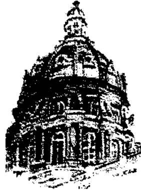
On behalf of the high technology industry, we write to thank you for introducing important legislation simplifying the application of state-level business activity taxes to interstate business. As you know, similar legislation is pending in the House (H.R. 1956). Current efforts by some states to impose their business activity taxes on business that have no physical presence in their states but merely have customers leads to uncertainty, litigation and needless administrative burdens on business. The physical presence standard contained in your bill would bring uniformity and certainty to the issue of when states may impose their business activity taxes on companies engaged in interstate commerce.

Many state tax regimes generally impose income and similar taxes on businesses that are "doing business" in the state. Revenue departments, without specific guidance from their legislatures, use their interpretative authority to construe the "doing business" standard as applying to any out of state business that has a customer in their state. They deny that the "physical presence" standard enunciated by the Supreme Court and which clearly applies to sales taxes, applies to business activity taxes. This assertion rarely sees litigation because states often apply it to smaller companies that do not have the resources to defend tax cases in far away states; when cases do arise, the courts generally affirm that the physical presence nexus standard applies. Congress should eliminate this uncertainty and wasteful litigation by clarifying that the physical presence standard is the appropriate standard for applying state business activity taxes to out-of-state businesses.

Again, thank you for your leadership on this very important issue. Please do not hesitate to contact us if we can be of any assistance to you on this or any other issue of important to the high technology industry.

Respectfully submitted,

AeA (American Electronics Association)
Information Technology Association of America
Information Technology Industry Council
Software and Information Industry Association
Software Finance and Tax Executives Council



CHRISTOPHER C. RANTS

Speaker, Iowa House of Representatives

May 16, 2006

The Honorable Charles Grassley
United States Senate
135 Hart Senate Office Building
Washington, DC 20510

Dear Senator Grassley:

We are pleased that a bipartisan group of Senators from both high population and rural states has introduced S. 2721, legislation that will simplify nexus standards for business activity taxes. We urge you to hold a hearing at the earliest convenience and ask that you support passage of this much-needed legislation.

We believe this is an issue nearing critical mass. The situation will continue to worsen unless Congress takes decisive action to clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and other direct taxes on a business.

Currently, some state and local taxing officials are aggressively attempting to apply economic nexus standards in order to collect business activity taxes from businesses located in other states that receive no appreciable benefits from the taxing jurisdiction.

As you may recall, in 2004, we recognized and communicated this problem to Congress by passing Iowa House Resolution 164 which asked Congress to enact legislation recognizing a physical presence standard for the imposition of state and local business activity taxes.

Federal corrective legislation has strong support from the Iowa business community, the Iowa legislature, and members of the Iowa congressional delegation. Among the Iowa business supporters are the Iowa Taxpayers Association, Iowans for Tax Relief, Iowa Motor Truck Association, as well as many individual companies. Congressmen Tom Latham and Steve King are original cosponsors of the House bill (HR 1956) that was reported last December from the House Judiciary Subcommittee on Commercial and Administrative Law.

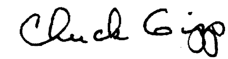
State Capitol, Des Moines, IA 50319 • (515) 281-5566 Des Moines • (712) 274-8874 Sioux City
christopher@rants.us • www.rants.us

This growing problem must be addressed at some point, and it will be easier to address sooner rather than later. Until resolved, businesses both large and small will suffer the unfairness and inequity imposed by some states' extreme taxation decisions. Until then, businesses must deal with increasing legal uncertainty and unstable business environments.

Federal clarifying legislation will ensure continued health and growth of U.S. and Iowa businesses, as well as create new jobs. We are encouraged that under your strong leadership this important legislation will be carefully considered. We look forward to working closely with you on this issue and hope to be of assistance.

Sincerely,

Christopher Rants
Speaker



Chuck Gipp
Majority Leader

Attachment: Iowa House Resolution 164

Cc: Senator Charles Schumer
Senator Mike Crapo
Senator John Thune
Senator Tim Johnson
Senator Jim DeMint
Senator George Allen
Senator Johnny Isakson
State Representative Jamie Van Fossen
David Young, Chief of Staff
Kolan Davis, Staff Director
Dean Zerbe, Tax Counsel
Bill Renaud. State Director

1 1 HOUSE RESOLUTION NO. 164
1 2 BY J. K. VAN FOSSEN
1 3 A Resolution requesting the United States Congress to
1 4 expand the physical presence standard for the
1 5 imposition of state and local business activity
1 6 taxes.
1 7 WHEREAS, the United States Supreme Court, in Quill
1 8 Corp. v. North Dakota, 504 U. S. 298 (1992), held that
1 9 remote sellers lacking a physical presence may not be
1 10 required to act as tax collection agents of the state;
1 11 and
1 12 WHEREAS, direct state and local taxes on
1 13 businesses, also known as "business activity taxes",
1 14 such as income, franchise, net worth, business
1 15 license, business and occupation, single business,
1 16 capital stock, and like taxes, impose an even greater
1 17 burden on businesses engaged in interstate commerce
1 18 than an obligation to collect a tax from consumers;
1 19 and
1 20 WHEREAS, the physical presence standard promotes
1 21 fairness by ensuring that businesses that receive
1 22 benefits and protections provided by state and local
1 23 governments pay their fair share for these services;
1 24 and
1 25 WHEREAS, the ability of state and local
1 26 jurisdictions to tax out-of-state businesses should be
1 27 limited to those situations in which the business has
1 28 employees or property in the taxing jurisdiction and
1 29 accordingly receives meaningful governmental benefits
1 30 or protections from the jurisdiction; and
2 1 WHEREAS, the physical presence standard results in
2 2 the proper attribution of business profits to taxing
2 3 jurisdictions where a business is located and thus
2 4 does not result in tax avoidance; and
2 5 WHEREAS, a business activity tax filing requirement
2 6 based on a standard other than physical presence
2 7 results in increased filing requirements and thus

2 8 increased compliance costs; and
2 9 WHEREAS, businesses currently rely on a physical
2 10 presence standard for complying with state and local
2 11 business activity tax obligations, and this standard
2 12 is applied currently by most state courts; and
2 13 WHEREAS, any congressional authorization for states
2 14 to impose a sales and use tax collection obligation
2 15 would further put businesses at risk of the unfair
2 16 application of business activity taxes by
2 17 jurisdictions in which the businesses lack a physical
2 18 presence; and
2 19 WHEREAS, the imposition of a standard other than
2 20 physical presence for business activity taxes would
2 21 expose United States companies lacking a physical
2 22 presence overseas to similarly expansive and unfair
2 23 taxation by foreign countries and their provinces; and
2 24 WHEREAS, businesses operating in interstate
2 25 commerce should not be compelled to pay taxes in state
2 26 and local jurisdictions solely as a result of the
2 27 business having customers located in the taxing
2 28 jurisdiction; and
2 29 WHEREAS, the United States economy has become more
2 30 global since Congress first enacted Pub. L. No. 86-272
3 1 and has shifted toward the provision of more
3 2 interstate services and intangibles, and providers of
3 3 services and intangibles are competitively
3 4 disadvantaged relative to businesses that only sell
3 5 tangible personal property; and
3 6 WHEREAS, the enactment of new business activity
3 7 taxes other than income taxes threatens to circumvent
3 8 the intent of Congress in enacting Pub. L. No. 86-272;
3 9 NOW THEREFORE,
3 10 BE IT RESOLVED BY THE HOUSE OF REPRESENTATIVES,
3 11 That the State of Iowa urges Congress to enact
3 12 legislation recognizing a physical presence standard
3 13 for the imposition of state and local business
3 14 activity taxes, defining de minimis standards for

3 15 measuring physical presence and setting reasonable
3 16 limits on the attribution of nexus, and updating Pub.
3 17 L. No. 86-272 to extend the current protections
3 18 available for the solicitation for sales of goods to
3 19 the solicitation for sales of services and intangibles
3 20 and to apply these protections to all business
3 21 activity taxes; and
3 22 BE IT FURTHER RESOLVED, That the State of Iowa
3 23 recognizes that any congressional approval of "sales
3 24 tax streamlining" without the simultaneous enactment
3 25 of these business activity tax measures would have a
3 26 harmful effect on American businesses and the economy;
3 27 and
3 28 BE IT FURTHER RESOLVED, That the Chief Clerk of the
3 29 House of Representatives shall forward a copy of this
3 30 Resolution to the Congress of the United States.
4 1 LSB 7081HH 80
4 2 mg/cf/24

May 18, 2006

Honorable Charles Grassley
Chairman, Senate Committee on Finance
United States Senate
Washington, DC 20510-6200

Dear Chairman Grassley:

The companies (both large and small), trade associations and citizen groups listed below strongly support S. 2721, the Business Activity Tax Simplification Act of 2006 ("BATSA"), and respectfully ask that you support the bill and schedule it for a hearing in the Senate Finance Committee as soon as possible.

BATSA, a bill recently introduced by Senators Michael Crapo (R-ID), Charles Schumer (D-NY) and others, would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and other direct taxes on a business (the bill would have no impact on sales and use or other non-income-based taxes). Specifically, the bill would articulate a bright-line physical presence standard that includes owning or leasing any real or tangible property, or assigning one or more employees to perform certain activities in the state for more than twenty-one days in a taxable year.

In addition, the bill would modernize Public Law 86-272 - which prohibits states from assessing net income-based taxes against an entity whose only contact with the state involves the solicitation of orders for tangible personal property - so that it applies also to intangible property and services and to all direct taxes on a business, not just those based on net income.

BATSA would ensure fairness, minimize costly litigation and create the kind of legally certain and stable environment that encourages businesses to make investments, expand interstate commerce and create new jobs. At the same time, the bill would ensure that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections.

Thank you in advance for considering our request. We look forward to working with you, your staff and all members of the Senate Finance Committee on the Business Activity Tax Simplification Act of 2006.

Sincerely-

American Bankers Association
American Century Investments
American Electronics Association (AeA)
American Express Company
American Homeowners Grassroots Alliance and the American Homeowners Foundation
American Hotel & Lodging Association
America's Community Bankers
Applebee's International, Inc.
Apple Computer
Association for Competitive Technology
Bank of America
Beall's, Inc.
Blue Crab Bay Co./Bay Beyond Inc.
Bob Petraglia, CPA (on behalf of numerous NY clients)
Business and Institutional Furniture Manufacturers Association (BIFMA) International
Business Roundtable
Capital One
CBS Corporation
Cendant Corporation
Chevron Corporation
Cisco Systems, Inc.
Citigroup, Inc.
Coalition of Service Industries
Computing Technology Industry Association (CompTIA)
Council for Citizens Against Government Waste
Direct Selling Association
Discovery Communications, Inc.
Entertainment Software Association
Expedia, Inc.
The Financial Services Roundtable
Gap Inc.
HSBC North America
IAC/InterActiveCorp.
Illinois Chamber of Commerce
Illinois Information Technology Association (ITA)
Information Technology Association of America
International Foodservice Distributors Association
International Franchise Association
International Paper

Investment Company Institute
Iowa Motor Truck Association
Iowa Taxpayers Association
Iowans for Tax Relief
Leggett & Platt, Incorporated
Limited Brands, Inc.
Magazine Publishers of America
MESDA: Maine's Software & Information Technology Industry Association
Mary Kay Inc.
MBNA
Metromedia Restaurant Group
Motion Picture Association of America, Inc.
National Association for the Specialty Food Trade, Inc.
National Association of Manufacturers
National Gypsum Company
National Marine Manufacturers Association
National Restaurant Association
National Retail Federation
National Taxpayers Union
NetChoice Coalition
Nike
North American Association of Food Equipment Manufacturers
Pasta Valente, Inc.
Printing Industries of America, Inc.
ProHelp Systems, Inc. (a home-operated S.C. business)
Roche Holdings, Inc.
Saks
Software & Information Industry Association
Software Finance and Tax Executives Council
Sony
Time Warner Inc.
The TJX Companies, Inc.
UPS
U.S. Chamber of Commerce
Vermeer Manufacturing
The Walt Disney Company
Wendy's International, Inc.
Wheeler Computer Services LLC (a S.C. small business)
Women Impacting Public Policy
Women Presidents' Organization
Yum! Brands, Inc.

May 31, 2006

By Telefax

Hon. Gordon H. Smith
U.S. Senate
Washington, DC 20510

Re: S. 2721, The Business Activity Tax Simplification Act

Dear Senator Smith:

On behalf of the Software Association of Oregon, I ask that you co-sponsor S. 2721, the Business Activity Tax Simplification Act (BATSA), a bill authored by Senators Schumer and Crapo. Businesses in Oregon constantly receive demands for tax returns and payments from states where they have customers but have no employees, property or other physical presence. This bill, if enacted, would provide certainty to businesses in Oregon as to which other states they would be required to pay income taxes and other taxes based on business activity and ensure that tax obligations only arise in states where they have employees or property.

Software plays a key role in Oregon's Innovation Economy and Software as a large traded sector industry mean big business to Oregon by providing opportunities of all sizes and in all parts of the state. In the Software industry, (not counting the hardware manufacturers like Intel and HP or the large number of IT organizations not in the tech industry) we have 4,000 software related companies generating almost $2 billion in total wages with an average wage of $64,000 per employee.

Many state tax regimes generally impose income and similar taxes on businesses that are "doing business" in the state. Revenue departments, frequently without specific guidance from their legislatures, use their interpretative authority to construe the "doing business" standard as applying to any out of state business that has a customer in their state. They deny that the "physical presence" standard established by the Supreme Court, which clearly applies to sales taxes, applies to business activity taxes.

BATSA would codify the constitutionally mandated physical presence standard and would provide bright-line rules by describing business activity that would trigger tax liability of non-resident businesses. Firm guidance on what activities a company can conduct within a state that will not trigger that state's taxing power will provide certainty to businesses and tax administrators and will reduce litigation and compliance and enforcement costs.

Again, on behalf of the Software Association of Oregon I ask that you co-sponsor S. 2721, the Business Activity Tax Simplification Act. Please feel free to contact me with any questions.

Respectfully submitted,

John Tortorici
President

May 31, 2006

By Telefax

Hon. Ron Wyden
U.S. Senate
Washington, DC 20510

Re: S. 2721, The Business Activity Tax Simplification Act

Dear Senator Wyden:

On behalf of the Software Association of Oregon, I ask that you co-sponsor S. 2721, the Business Activity Tax Simplification Act (BATSA), a bill authored by Senators Schumer and Crapo. Businesses in Oregon constantly receive demands for tax returns and payments from states where they have customers but have no employees, property or other physical presence. This bill, if enacted, would provide certainty to businesses in Oregon as to which other states they would be required to pay income taxes and other taxes based on business activity and ensure that tax obligations only arise in states where they have employees or property.

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BATSA would codify the constitutionally mandated physical presence standard and would provide bright-line rules by describing business activity that would trigger tax liability of non-resident businesses. Firm guidance on what activities a company can conduct within a state that will not trigger that state's taxing power will provide certainty to businesses and tax administrators and will reduce litigation and compliance and enforcement costs.

Again, on behalf of the Software Association of Oregon I ask that you co-sponsor S. 2721, the Business Activity Tax Simplification Act. Please feel free to contact me with any questions.

Respectfully submitted,

John Tortorici
President

ProHelp Systems, Inc.

418 East Waterside Drive
Seneca, SC 29672
sales@prohelp.com
(864) 885-0094
Fax: (864) 885-0880
www.prohelp.com

June 19, 2006

The Honorable Charles E. Grassley
Chairman, Senate Finance Committee
Washington, DC 20510

The Honorable Max Baucus
Ranking Member, Senate Finance Committee
Washington, DC 20510

Dear Chairman Grassley:

The Business Activity Tax Simplification Act of 2006, BATSA S. 2721, is of ***extreme importance*** to every one of our Nation's small businesses. I urge you to completely disregard what the Nation's Governors have told you. It is pure hogwash; I know because my ***home-based*** micro business (I am not big enough to be called small!) has experienced the ordeal of fighting an unfair and even unconstitutional BAT tax imposed by the State of New Jersey.

Because I testified to the House Judiciary Subcommittee on Commercial and Administrative Law last September, and submitted information for the record the prior year, I have become aware of approximately ***thirty*** more small businesses with similar problems. It is incredible, but true, that these small businesses are so desperate for help and relief, they seek ***me*** out for advice. It is also incredible, but true, that a number of attorneys have even called me, asking for advice on how to deal with a quickly growing National problem.

The history of our Country well demonstrates that, once initiated, new taxes spread quickly. Without strong Federal legislation, our experience proves that small businesses will soon be unable to participate in Interstate Commerce. We are speaking up because thousands of small businesses are ***totally unaware*** of the risks. They are too busy just trying to survive; they don't even know what nexus means. But they quickly find out when a nexus auditor comes calling, and then they search for me. Then, they immediately become ***afraid*** to speak up; so that burden falls to me. Let me tell you what happened to our business.

In 1997, we sold one copy of our licensed software product to a customer in New Jersey for $695. Because of this single sale, the State of New Jersey demanded that we pay $600 in taxes and fees, ***every year the software remains in use, even in years with no sales, and regardless of any profit.*** Despite numerous lawsuits, New Jersey will **not** allow small, out-of-state businesses to sell products and services without paying unconscionable taxes.

Should all 50 States adopt New Jersey's Corporate Business Tax, small software developers selling just one license in every State would owe $30,000 in business activity taxes ***every year thereafter, even with no additional sales anywhere***. Should localities follow suit, the results would truly be astronomical. And you can be certain: If our Country disavows the current strong physical presence standard (permanent establishment) for business taxation ***within*** our Country, then foreign countries will seek to re-negotiate trade pacts based on that standard; and the thirty-three countries we have sold our software in will come calling for us as well. Our company derives only about $40,000 in total ***sales*** per year from our software products! These are all very powerful reasons to stay out of the software business.

But, the abuse is ***not*** limited to software. New Jersey even defies protections of the Interstate Income Tax Act of 1959 (PL 86-272), which prevents States from imposing income tax for Interstate activities where no physical presence exists. Today, if a small business ships just a box of paper clips to a customer in New Jersey, he will be subjected to the same tax. Further, the attached page, derived from the 2005 BNA survey of state revenue departments, shows ***numerous*** additional traps awaiting unsuspecting small businesses because of unconscionable nexus laws. The 2006 BNA study shows how quickly the problem has escalated in just the past year. New Jersey is ***not*** the only state making unconscionable claims against small businesses!

These nightmares are certain to escalate. New Jersey increased its minimum tax ***150%*** in 2002. This tax is effectively borne only by the smallest participants in Interstate Commerce. The victims are generally not capable of fighting, they capitulate to reduce the risk of larger penalties, and they have absolutely no representation in the matter ***except in the Congress.*** Why should anyone believe this tax will not soon be increased again, and spread to other States? Without the clear protections BATSA provides, aggressive States will always seek to stretch the limits and to impose their own creative definitions to justify taxation most citizens consider highly unjust.

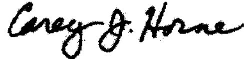
No small business can possibly cope with the widely varying and ever changing laws of 50 States, the administrative burdens of keeping records by State, or the costs of preparing and filing multiple returns. Nor can we afford to pay inflated tax claims or legal fees required to defend against them. Without strong Federal legislation, small businesses will soon be unable to participate in Interstate Commerce ***at all.***

As Congressman William Delahunt said during the hearing last year, "The case presented by Mr. Horne, I think, is an egregious example. We support you, Mr. Horne, and it's got to be addressed."

Our Founding Fathers wisely added the Power to regulate Commerce among the states to our Constitution because they experienced identical issues, and they greatly harmed the National economy in those days as well. The concept of physical presence has been the primary basis for business taxation since then, and the attempts to change it are wreaking havoc upon us, ***once again.***

I urge you to hold a hearing on BATSA as quickly as possible. Our Nation's millions of small businesses need permanent relief ***this year***. As their de facto representative, I call upon you to pass BATSA, ***this year***, so we can get back to our job of growing our businesses instead of fighting greedy States making unconscionable claims. I would be more than happy to tell my story in person to the Senate Finance Committee, again at substantial personal expense, because simply put, small businesses cannot participate in Interstate Commerce without the protection BATSA provides.

Sincerely,



Carey J. Horne, President

cc: **Members of the Senate Finance Committee:**
The Honorable Orrin G. Hatch
The Honorable Trent Lott
The Honorable Olympia J. Snowe
The Honorable Jon L. Kyl
The Honorable Craig Thomas
The Honorable Rick Santorum
The Honorable Bill Frist
The Honorable Gordon Smith
The Honorable Jim Bunning
The Honorable Mike Crapo
The Honorable John D. Rockefeller IV
The Honorable Kent Conrad
The Honorable James M. Jeffords
The Honorable Jeff Bingaman
The Honorable John F. Kerry
The Honorable Blanche L. Lincoln
The Honorable Ron Wyden
The Honorable Charles E. Schumer

Additional Senators, States where ProHelp is registered:
The Honorable Saxby Chambliss
The Honorable Lindsey O. Graham

Additional co-sponsors of S-2721:
The Honorable George Allen
The Honorable Jim DeMint
The Honorable Tim Johnson
The Honorable Johnny Isakson
The Honorable John R. Thune

Additional Members of the Senate Committee on Small Business and Entrepreneurship:
The Honorable Christopher S. Bond
The Honorable Conrad Burns
The Honorable Norm Coleman
The Honorable David Vitter
The Honorable Michael B. Enzi
The Honorable John Cornyn
The Honorable Carl Levin
The Honorable Tom Harkin
The Honorable Joseph I. Lieberman
The Honorable Mary Landrieu
The Honorable Maria Cantwell
The Honorable Evan Bayh
The Honorable Mark Pryor

Economic Nexus Creates Nexus Nightmares for Small Businesses

What is nexus? States say you have nexus if you are "doing business there". Each State defines nexus totally differently (that is one of our problems!), but once a State declares that you have it, you are subject to the entire variety of taxes that State imposes. **The vast majority of small businesses assume they are doing business in their home State only.** Many States think otherwise, and there are a variety of major traps that easily create "**nexus nightmares**" for us.

All but a few small businesses are totally unaware of these traps. Some do not even require that an interstate sale be made! They are simply a time bomb waiting to trap *all* small businesses within *any State.*

Once nexus is triggered for ***any*** reason, appropriate registrations and fees must be submitted promptly and applicable tax returns must be timely filed to prevent penalties and interest that can grow quickly to exceed the tax due. Some States don't even recognize, or just totally deny, the S Corporation election, requiring you to file the same return as Microsoft and General Motors! All of the rules vary ***widely*** by State; but if the customer happens to be in New Jersey, any sale of any type, even a small box of paper clips, may trigger an immediate liability of $600, ***continuing every year until critical steps are taken to terminate nexus.***

State tax administrators have explicitly indicated they will impose taxation on a business if that business merely performs one of these common activities[2]:

- **35 States:** Any sale in the State is risky as no well-defined standard protects de minimis activity.
- **Michigan, New Jersey, Ohio, and Texas: *Anything*** is sold in the State; ***the protections of the Interstate Income Tax Act of 1959 (Public Law 86-272) don't apply!***
- **14 States:** A website is simply hosted on a server within the State; ***making sales through the website is not a requirement!*** Few small businesses have any idea where their hosting servers are located until they ask their providers; tell your constituents to ask about theirs today!
- **16 States:** A truck drives through the State, ***without even stopping.***
- **28 States:** An agent in the State is used to check the creditworthiness of customers in the State.
- **New Jersey:** An agent is used to make sales in the State.
- **11 States:** A small sale is made at a trade show in the State.
- **7 States:** A registration of some type is filed with the State.
- **12 States:** A telephone number is listed in a directory in the State.
- **4 States:** A bank account is opened in the State.
- **7 States:** A loan is negotiated with or obtained from a bank in the State.
- **34 States:** Intangible property, such as licensed software, is sold in the State.
- **Minnesota:** If a healthcare provider outside Minnesota solicits for healthcare services within Minnesota, but provides the actual service in **another** State, nexus is created in Minnesota. This trap applies directly only to healthcare providers, which are generally large businesses. But, it can limit the availability, and increase the price, of healthcare which is probably the largest issue facing small businesses today.

2. 2005 BNA survey of 47 State Departments of Revenue

CJH 10/4/05

J. Denis O'Toole
Senior Vice President
Government Relations

July 17, 2006

The Honorable Charles Schumer
United States Senate
Washington, DC 20510

Re: S 2721, Business Activity Tax Simplification Act

Dear Senator Schumer:

On behalf of HSBC North America Holdings, Inc. and its more than 10,000 New York employees, I would like to commend you for introducing S 2721, the Business Activity Tax Simplification Act ("BATSA"). Your legislation addresses the need to clarify and modernize the nexus rules that govern the states' ability to impose income taxes on companies that do not have a physical presence in the taxing jurisdiction.

Specifically, your bill will clarify that physical presence is the constitutional standard for the imposition of corporate income taxes and will establish a bright-line physical presence nexus standard. Importantly, the bill would not impose any new restrictions on the states' taxing power. It would only clarify the states' existing authority to tax interstate commerce. Businesses would continue to pay income taxes in those jurisdictions where they receive direct benefits.

By enacting BATSA, Congress will satisfy its constitutional responsibility to ensure that interstate commerce is not burdened by state actions. Enactment of the bill would ensure fairness, minimize litigation, promote a level playing field for taxpayers by providing a bright-line standard governing taxation and foster the kind of legally certain and stable business climate that encourages business investment, expands interstate commerce, creates new jobs and leads to a healthy economy.

On behalf of HSBC North America, I thank you for your leadership, and we offer our support and assistance.

Sincerely,

J. Denis O'Toole

J. Denis O'Toole

HSBC - North America
1401 I Street, NW, Suite 520, Washington, DC 20005
Tel: (202) 466 3561 Fax: (202) 466 3583

July 18, 2006

Honorable Max Baucus
Senate Finance Committee
United States Senate
Washington, DC

Dear Senator Baucus,

We are writing to request your support of the Business Activity Tax Simplification Act (S.2721). The bill would clarify the physical presence nexus standard for the collection of business activity taxes.

The changing economy is challenging the interpretation of States' nexus tax laws. This lack of clarification has resulted in the imposition of various business and income taxes on out-of-state companies by states and cities and towns. Taxes are being assessed even if the business has no physical presence or employees located in the state.

Federal legislation is warranted to protect businesses from "taxation without representation" and to provide a standard of taxation among the states. The Act will ensure each state retains their right to impose taxes on businesses having a physical presence in the state while providing predictability and stability to the taxpayer.

Thank you for your consideration. Thanks again for representing the taxpayers in Montana and for your hard work on the Senate Finance Committee.

Sincerely,

Mary Whittinghill
President
Montana Taxpayers Association

Steve Turkiewicz
President
Montana Bankers Association

Webb Brown
President
Montana Chamber of Commerce

Brad Griffith
President
Montana Retail Association

1201 New York Avenue, NW • #600 • Washington, DC 20005
Tel. 202-289-3120 • Fax 202-289-3186 • www.ahla.com

Governmental Affairs Department

Marlene M. Colucci
Executive Vice President for Public Policy

July 19, 2006

The Honorable Craig Thomas
Chairman, Subcommittee on International Trade
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Thomas:

On behalf of the American Hotel & Lodging Association (AH&LA) and its 10,000 members I am writing to ask for your support of S 2721, the Business Activity Tax Simplification Act (BATSA).

During the last several years, many states have sought to increase their tax revenue by imposing taxes on businesses which have no physical presence in those states. Although clearly unfair and economically harmful, these states have done so because currently no clear standard exists to define a substantial nexus for the taxation of business activity by the states. In addition, different states use different standards for determining what constitutes sufficient contacts with a state to justify taxation. As a result, businesses have been reluctant to expand their presence in other states because of their concern of being exposed to further taxation.

In order to modernize and clarify the law, S 2721 will create a fair, clear, and uniform nexus standard for the imposition of business activity taxes by states and localities. BATSA will modernize existing law to ensure that states and localities only can impose their business activity taxes in situations where an entity has physical presence and receives related benefits and protections from the jurisdiction.

BATSA would ensure fairness, minimize costly litigation and create the kind of legally certain and stable environment that encourages businesses to make investments, expand interstate commerce and create new jobs. At the same time, the bill would ensure that businesses continue to pay business activity taxes to states that provide them with direct benefits and protections.

It is critical that a physical presence nexus standard should be established in order to ensure an equitable and measurable application of the state tax laws for all industries. I strongly encourage you to support S 2721.

Sincerely,

Marlene M. Colucci

Marlene M. Colucci

THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

E-Mail info@fsround.org
www.fsround.org

July 24, 2006

The Hon. Chuck Grassley
United States Senate
Washington, DC 20510

Dear Chairman Grassley:

The Financial Services Roundtable applauds the action of the Senate Committee on Finance to hold a hearing on S. 2721, *the Business Activity Tax Simplification Act.* This important legislation will simplify tax law by establishing a clear test to define when states can tax the business activity of businesses physically located in another state.

In 1992, the U.S. Supreme Court ruled in Quill Corp. v. North Dakota that a state could not impose taxes on an out-of-state business unless that business has a "substantial nexus" within the taxing state. However, the Court left to Congress the task of defining the nexus standard to be applied to business activity taxes.

New business activities, like sales over the internet, have created confusion about when states may collect income taxes from out-of-state companies. Unfortunately, states are defining "substantial nexus" differently, leading to 50 different tax regimes. This makes it difficult for financial services firms to conduct business efficiently.

S. 2721 ends these harmful practices by establishing specific standards that define when businesses should be obliged to pay business activity taxes. The legislation ensures fairness, minimizes litigation, and creates a legally certain business climate that encourages companies to invest and expand interstate commerce.

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO.

Roundtable member companies provide fuel for America's economic engine, accounting directly for $50.5 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

Again, we thank you for the Committee's action on S. 2721, and if you have any questions, please do not hesitate to contact me or Scott Talbott at 202-289-4322.

Best regards,

Steve Bartlett
President and CEO

Statement of Senator Byron Dorgan
Senate Finance Subcommittee on International Trade Hearing on "How Much Should Borders Matter?: Tax Jurisdiction in the New Economy"

July 25, 2006

Chairman Thomas and Ranking Member Bingaman, I would like to thank you for holding this Subcommittee hearing today to examine tax issues that are of utmost importance to state and local governments and the businesses that operate inside their borders. I appreciate the opportunity to offer my thoughts on this matter.

For many years, some Internet and catalog sellers have argued that it is unfair to require them to collect and remit sales taxes, and they argue that trying to comply with over 7,000 taxing authorities across the country would be unduly burdensome and costly. Frankly, I think that is a legitimate complaint.

At the same time, however, many states and localities depend on sales taxes to help fund a range of local activities, from education and fire suppression to police protection and road construction. Yet billions of dollars in sales tax revenues go uncollected year after year in many jurisdictions due to a ruling (Quill vs. North Dakota) by the U.S. Supreme Court in 1992 that said current state and local sales tax systems impose an impermissible burden on sellers that do not have a physical presence in each state. The U.S. Supreme Court in the Quill case said that states and localities must dramatically reduce the complexity and burden of their sales tax systems before they could require out-of-state sellers to collect sales taxes.

Senator Mike Enzi of Wyoming and I have been working closely for several years on federal legislation that encourages and rewards state and local governments that radically simplify their sales tax systems by granting them authority to require large sellers to collect taxes on remote sales after such simplifications are implemented. To their credit, the states have stepped up to the challenge outlined in the Quill decision. States have been working with the retail community and local governments for over five years now to develop a streamlined and uniform sales tax system agreement that will alleviate the burden of sales tax collection for both local retailers and remote sellers.

The Streamlined Sales and Use Tax Agreement, which was approved by 34 states and the District of Columbia in November 2002, requires participating states to comply with dozens of stringent simplification requirements that streamline how state sales and use taxes are identified and collected. Today, 19 states have enacted legislation to bring them into compliance with the Agreement.

By harmonizing state sales and use tax rules, bringing uniformity to definitions in the sales tax base, significantly reducing the paperwork burden on retailers, and incorporating a seamless electronic reporting process, states that comply with the Agreement will significantly reduce tax collection burdens on all sellers. In return, we believe these states ought to be able to require large sellers to collect taxes on remote sales. This result would benefit state and local governments that

lose billions in sales tax related revenues under the current system. It would also be good news for local retailers on the nation's Main Streets who already collect sales taxes from their customers and therefore must often compete against remote sellers who are not required to collect the tax.

Let me emphasize an important point. The bills that Senator Enzi and I have authored do not impose new taxes on anyone, and we are certainly not imposing new taxes on Internet sales. We are only talking about taxes that customers already owe under state law but which go uncollected.

Having said that, Senator Enzi and I believe it is critically important that new collection responsibilities under the Streamlined Sales Tax Project do not unduly burden start up and other small remote sellers. That is why the legislation we are advancing provides for a small remote seller exemption.

The bill I introduced, S. 2153, is identical to Senator Enzi's bill in every respect but the small seller exemption. His legislation provides a small business exemption with a specific dollar threshold, while my proposal requires the Small Business Administration (SBA), after considering all relevant factors and soliciting input from the Treasury Department, the Streamlined Sales Tax Governing Board and others, to develop a rulemaking and propose to Congress a definition of those small sellers, including small businesses, which would not be required to collect and remit sales and use taxes. S. 2153 provides for the expedited consideration of SBA's proposal by the U.S. House and Senate and takes steps to ensure that a small seller exemption will ultimately be approved by Congress. States would be allowed to require large remote sellers to collect sales taxes only after federally-mandated simplification is accomplished and a small seller exemption is approved by Congress.

As the volume of remote on-line retail sales grow, states are losing more and more sales tax revenue. This threatens the future ability of states and localities to make critical investments in even the most basic community services, while forcing local retailers who are required to collect sales taxes today to compete with large remote competitors who are not. Senator Enzi and I are determined to address this problem.

I think the general approach that Senator Enzi and I have recommended strikes a reasonable balance between the interests of consumers, local retailers, remote sellers and the states. And I look forward to working with Senator Enzi, you and other members of the Finance Committee to address any remaining questions about our legislation and to move the legislation forward in the U.S. Senate.

Hearing: "How Much Should Borders Matter?: Tax Jurisdiction in the New Economy"
Senate Finance Subcommittee on International Trade
Senator Michael B. Enzi
July 25, 2006

Thank you, Chairman Thomas, for allowing me to testify this morning about the importance of imposing uniformity, simplification, and fairness concerning the taxation of remote sales over the Internet. I appreciate you and Senator Bingaman holding this hearing today to discuss this important issue.

I have been working on this issue since joining the U.S. Senate in 1997. As a former small business man, it is important to level the playing field for all retailers – in-store, catalog, and online – so an outdated rule for sales tax collection does not adversely impact small businesses and Main Street retailers. I believe S. 2152, The Sales Tax Fairness and Simplification Act achieves this goal in accordance with the simple rules provided for all businesses under the Streamlined Sales and Use Tax Agreement.

On December 20, 2005, I introduced S. 2152, The Sales Tax Fairness and Simplification Act, a bill that will treat all retailers – in-store, catalog, and online – in a similar fashion so each retailer has the same sales tax collection responsibility. All businesses and their retail sales should be treated equally. It is unfair that our current tax structure gives remote sellers an advantage over small businesses and Main Street retailers.

By addressing this collection inequity, the bill will also help states ensure the viability of the sales tax as a major revenue source for state budgets by closing a growing loophole that encourages tax avoidance. This bill is not a disguised attempt to increase taxes or put a new tax on the Internet. Consumers are already supposed to pay sales and use taxes in most states for purchases made over the phone, by mail, or via the Internet. Unfortunately, most consumers are unaware they are required to pay this use tax on purchases the retailer does not choose to collect sales tax on at the time of purchase.

Consumers who buy products online are required by law to keep track of their purchases and then pay the outstanding use tax obligation on their state tax forms. This has proven to be unrealistic, since most people do not know this or do not comply with the requirement. As such, states are losing billions of dollars in annual revenue. This legislation will help both consumers and states by reducing the burden on consumers and providing a mechanism that will allow states to systematically and fairly collect the taxes already owed to them. At a time when states are increasingly turning to the federal government for program funding, it is logical that Congress would instead authorize the states to collect their own revenue instead of raising the federal tax burden to then distribute money back to the states.

This bill is not about new taxes. In fact, it is likely that the states' dependency on federal dollars could be offset by any increased collection at the state level. If Congress fails to authorize states to collect tax on remote sales, and electronic commerce continues to grow as predicted, are we implicitly blessing a situation where states will be forced to raise other taxes – such as income or

property taxes – to offset the growing loss of sales tax revenue? I want to avoid that. That is why we need to implement a plan that will allow states to generate revenue using mechanisms already approved by their local leaders.

This bill is about economic growth. Sales and use taxes provide critical revenue to pay for our schools, our police officers, firefighters, road construction, and more. It will put local businesses on a level playing field with their online competitors. To some businesses, an even more important aspect of this legislation is that it simplifies the compliance burden faced by business today. By ensuring that the member states and local governments are required to simplify their tax structure, the administrative and audit burden is reduced on all business. The business resources that have historically been spent on tax compliance could now be used, among other things, to hire new employees and buy new equipment.

This bill accomplishes tax simplification in an unprecedented manner. As the Supreme Court identified in the Quill versus North Dakota decision in 1992, the complicated state and local sales tax systems across this country have created an undue burden on sellers – one that could not fairly be placed on a remote vendor. The Quill decision stated that a multitude of complicated and diverse state sales tax rules made it too onerous to require retailers to collect sales taxes unless they had a physical presence in the state of the buyer. Local brick-and-mortar retailers collect sales taxes, while many online and catalog retailers are exempt from collecting the same taxes if they can argue that they do not have physical presence in the state. This is not only fundamentally unfair to Main Street retailers, most of whom are small businesses, but it is costing states and localities billions of dollars in lost revenue.

S. 2152 will help relieve the expensive burden by requiring states to meet the simplification standards outlined in the Streamlined Sales and Use Tax Agreement. Working with the business community, the states developed the Agreement to harmonize state sales tax rules, bring uniformity to definitions of items in the sales tax base, significantly reduce the paperwork burden on retailers, and incorporate new technology to modernize many administrative procedures. This unprecedented Agreement will increase our nation's economic efficiency and facilitate the growth of commerce by dramatically reducing red-tape and administrative burdens on all businesses and consumers. However, most importantly, the Agreement removes the liability for collection errors from the retailer and places it with the state. This historic Agreement was approved by 34 states and the District of Columbia on November 12, 2002.

The states have made tremendous progress in changing their state tax laws to become compliant with the Agreement. Already, 19 states have enacted legislation to change their tax laws and implement the requirements of the Agreement. On October 1, 2005, the Streamlined Sales and Use Tax Agreement became effective. Since that date over 350 businesses have voluntarily signed up to begin collecting sales tax under the simplified set of rules.

While the states have made great progress, the Quill decision held that allowing states to require collection is an issue that, "Congress may be better qualified to resolve, and one that it has the ultimate power to resolve." The states have acted. It is now time for Congress to provide states that enact the Streamlined Sales and Use Tax Agreement with the authority to require remote retailers to collect sales taxes just as Main Street retailers do today.

Senator Byron Dorgan of North Dakota and I have worked tirelessly to assist sellers and state and local governments to find true simplification in almost every aspect of sales and use tax collection and administration. Last year, Senator Dorgan and I worked with all interested parties to try to find a mutually agreeable legislative package to introduce. Many hours have been dedicated in trying to find the right solution to address all concerns, especially the small business exception. Senator Dorgan and I introduced two separate bills, but will continue to work with each other and all interested parties to find compromise on the outstanding policy issues of concern to the stakeholders. Bill introduction does not stop us from negotiating and working together to improve the final product that should be enacted into public law.

The Sales Tax Fairness and Simplification Act provides states that implement the Streamlined Sales and Use Tax Agreement with the authority to collect sales or use taxes equally from **all** retailers. Adoption of the Agreement **and** Congressional authorization will provide a level playing field for brick and mortar and remote retailers.

Thank you again, Chairman Thomas, for the opportunity to outline the importance of introducing S. 2152. I look forward to working with you, your staff, and the rest of the Finance Committee on this policy initiative in the future to ensure swift passage of S. 2152.

WRITTEN TESTIMONY OF GARY IMIG

Subcommittee on International Trade of the Committee on Finance

July 25, 2006

It is an honor to submit my testimony in regard to internet taxation to this Subcommittee on International Trade.

I am Gary Imig, Executive Vice President of Sierra Trading Post, Inc. Sierra Trading Post is a 20 year old direct marketing company, founded in 1986 by Keith and Roberta Richardson. We currently employ 800 people in three separate locations in Wyoming and Nevada. We have close to three million customers across the U.S. We also sell our products in several foreign countries. We will mail approximately 60 million catalogs this year. Our website, on average, gets close to 75,000 unique visitors per day, and our revenue from the website ranks us as the 75th largest retail website by revenue in the *Internet Retailer Top 500 Guide*. And even with all of this, we are a very typical mid-range small business.

I feel that it is very important for me to be here today to present my testimony to help protect and nurture the direct marketing industry, an industry that I deeply care about. When I refer to the direct marketing industry, I am referring to both sales through a catalog and sales through the web. These two areas have blended so much over the last several years that they have become one in many ways. I believe the direct marketing industry is one of the last truly great industries that encourages entrepreneurial risk taking. The evolution of the internet, in conjunction with catalog mailings, has allowed many undercapitalized, entrepreneurial people with good ideas to form companies. The good thing about these startups is that they can happen anywhere, on the farms of Kansas to the

inner city neighborhoods of Detroit. The internet has allowed many of these companies to compete with much larger companies on a level playing field. The creativity and imagination currently coming out of our industry is breathtaking. Almost daily, Sierra Trading Post is reinventing the way we sell to our customers. It is a very exciting time, but also a very dangerous time. Many new direct marketing startups occur every day. Sadly, many also cease to exist every day.

Several years ago I had the pleasure of listening to a speech that Mike Sullivan, then Governor of the State of Wyoming, gave to a group that I was a part of. This was right after he had finished his two terms as Governor. He talked about the "Homogenization of America." He and his wife had recently taken some time off to travel America, and he was shocked at how different areas of the country looked so much the same. From the interstates, everything looked eerily similar. Of course, there was always a McDonalds. Also, there was always a Wal-Mart around the corner. All the usual examples were there. There were grocery store chains, fast food chains, shoe store chains, and discount store chains. There were chain stores for everything. Mike wondered what had happened to the uniqueness of America. I agree with him. America did not become great, and its economy did not become great, by being the same. This uniqueness is what I believe our industry offers the consumer. Our entrepreneurial thoughts encourage freshness and creative product offerings. We would not exist as companies if we could not somehow differentiate ourselves from the behemoths that occupy the consumer retail space. Sierra Trading Post could never compete with a Wal-Mart or a Target. Sierra Trading Post competes by how we service our customer, the uniqueness of our product offerings, and our low cost direct marketing structure.

This entrepreneurial explosion in the direct marketing business and on the web has not been lost on entrenched consumer retail forces. All of a sudden, large retail

chains, which have squeezed their markets to the point where small business can no longer compete against them for the retail consumer, are now faced with a whole set of new competitors. These competitors are quicker and more flexible. They take care of their customer better, and in a lot of ways, pay much better attention to the needs of their customers. And these new, quicker competitors have begun to take market share from these retailers.

SO HOW DID THESE RETAIL FORCES REACT TO THIS NEW COMPETITOR?

I submit to you that my being here in front of this committee is one of the results of how big retail and its allies felt they needed to address this competitor. The statement that is always made by the retail industry is, "You need to level the playing field. Make them charge taxes like we do." Of course, what these interests don't mention is that we charge shipping, which in most instances is greater than sales tax. We don't have a competitive advantage in this area, and they know it. They know that if we have to charge sales tax up front, we will probably have to cut our shipping charges to make our offerings attractive to the customer. And in this day and age of ever rising fuel charges and postal rates, this will substantially impact our bottom line. This could also have a significant impact on new startups in our industry and overall growth. They know this, and that is why they are pushing it.

There is one significant fallacy in this debate about internet taxation. Many people think that the players in this debate are very large companies. If you look at the top 500 retail websites in the U.S., you will see very quickly that this is not true. This might be true with the top 50 sites, but after the top 50 sites, you start getting into typical small business territory. If it is not a small business, then it probably is

a company that not only has a website, but a lot of retail locations already paying sales tax. A look at the top 50 sites would include such companies as Office Depot, Staples, Office Max, Sears, Kmart, Best Buy, Wal-Mart, J.C. Penney, Target, etc. All of these entities are probably paying sales tax because of their physical locations. It is very important to keep in mind when anyone starts talking about internet taxation and its effect, they're not talking about big business. Make no mistake, this is about small business; this is about the creativity of small business and the development of jobs in small business. In fact, the 500th largest retail website on the *Internet Retailer Top 500 Retail Websites* list has only three million in sales from the web.

SO, HOW DO WE ADDRESS THE ISSUE THAT IS BEFORE US TODAY?

First and foremost, I would suggest caution. This is not just about sales tax leakage. In fact, in my opinion, the leakage is overstated. If you eliminate the players from the debate that are large retailers or very large web pure plays (like Amazon and Ebay), that leaves about 15 to 20 billion dollars in sales a year generated by the remaining top 500 retail websites. This seems like a lot, but in my opinion it adds up to about a billion dollars per year in sales tax revenue leakage. Dividing this up between all the U.S. tax authorities does not give much to each.

Instead, this discussion and issue is about small business. It is about maturing small entrepreneurial startups. This discussion is about recognizing that we want unique offerings for consumers, not the homogenized offerings we, as a country, are quickly rushing toward. This is about job creation. It is about creating jobs in areas where new job creation is hard to do. Sierra Trading Post is a good example of this. We have created 500 new jobs over the last 14 years in Cheyenne,

Wyoming. We have added 150 new jobs in Cody, Wyoming. Remember, this industry levels the playing field; this industry allows somebody with a bright idea and very little money to get in the game. This drives big business crazy. Finally, this discussion is about a still fledgling industry. Direct marketing, and especially selling over the web, is still in its formative stages. Don't let people kid you. Selling over the web is not close to maturing. It has a bright future, but perils abound. Significant additional financial and governmental red tape and roadblocks will dampen this entrepreneurial engine. I would not like to see this happen, and I don't believe you would either.

SO, WHAT WOULD I RECOMMEND?

My recommendations on this issue are twofold. I believe the concept of Nexus is paramount. If an entity has a physical presence in a state, then I believe that entity needs to collect sales tax in that state. Sierra Trading Post religiously adheres to that concept. I believe Nexus should be strictly enforced and defined further, if necessary. This philosophy predates the web and has worked well for years with the catalog direct marketing industry. Secondly, I believe that we, as an industry, need to quit playing shell games. Nexus is Nexus. Setting up operations in separate companies, holding companies, etc. does not negate Nexus. We need to be honest in this.

I know there is a significant rush toward tax simplification in an effort to tax internet sales. There is a lot of pressure on this committee and this body to address these issues. Many governmental entities are clamoring for you to address this. This is all being done in the guise of fairness and the belief that there is leakage of tax revenue. I would urge you to be very cautious, however, before you rush into a tax program. As already mentioned in this discussion, in my opinion this isn't

about fairness or leakage. It is about small business and job creation. I'm afraid that people will rush to grab the gold ring of internet taxation, and when they grab it, discover the ring is not gold but dust because of the burden of implementing, managing, and collecting this tax revenue. And this more burdened taxation structure, I'm afraid, will also result in a loss of jobs and entrepreneurial creativity.

In closing, I would like to relate a personal anecdote. One of the people who works for me has a friend in Oregon, in John Day, Oregon, to be exact. This friend was a struggling antique dealer until she decided to sell her pieces over the internet. Her husband had some expertise in setting up websites, so she convinced him to set up a website for her. After setting up her website, years of frustration melted away. Almost immediately she started getting a trickle of new sales from the web. The web has allowed her to keep her business open even during the tourist off-season. She is a very specific example of what I have been saying. Be careful not to hurt this small business engine.

I appreciate your time on this matter and my ability to discuss this with you.

Gary Imig
Executive Vice President
Sierra Trading Post

Questions for the Record From Mr. Gary Imig
July 25, 2006

From Senator Hatch:

Mr. Imig, what is your opinion about the simplified compliance software that Mr. Noble mentioned in his testimony? Have you had a chance to use this software, or have you had any experience with it? Also, the Enzi legislation includes a small business exemption of $5 million. Is this too low? If so, what do you think is the right level of small business exemption?

Question #1
I have no working knowledge of the simplified compliance software mentioned in Mr. Noble's testimony. I'm not certain who developed this software and whether anyone in the direct marketing industry has tested it. I'm reasonably active in the direct marketing industry, and I know of no one that has tested or used this software. My greatest concern about this software is whether it can interface with the fairly sophisticated programs we use in the direct marketing business and whether it can handle the volume of business that many companies, like ours, have.

Question #2
My initial reaction to a small business exemption was to agree that we should have one. Per my testimony, I believe the direct marketing industry is one of the last truly entrepreneurial industries left. As such, an exemption for smaller businesses is probably good. Unfortunately, the endangered species in business today is not the small or large company. Increasingly, the mid-range company is being squeezed out of existence. The small company does not have the structural needs and capital commitments of a mid-range business, whereas a large business can tap the financial markets. For that reason, if misguided legislation like this is passed in regard to internet taxation, then I believe all of us should share equally in the pain.

Testimony of George S. Isaacson, Esq.
Tax Counsel for the Direct Marketing Association
Before the United States Senate
Finance Committee
Subcommittee on International Trade
July 25, 2006

WHY THE STREAMLINED SALES AND USE TAX AGREEMENT IS FUNDAMENTALLY FLAWED AND DOES NOT JUSTIFY JEOPARDIZING CORE AMERICAN PRINCIPLES OF FEDERALISM AND FREE–FLOWING INTERSTATE COMMERCE

Mr. Chairman, Members of the Committee, on behalf of the Direct Marketing Association ("DMA") and its membership, I want to thank you for the opportunity to testify on this important issue. The DMA is the largest trade association for businesses interested in direct marketing to consumers and businesses via catalogs and the Internet. Founded in 1917, the DMA today has over 4,700 member companies in the United States and 53 foreign countries.

As an attorney practicing in the area of sales and use tax law for more than 25 years, and an instructor in Constitutional Law at Bowdoin College, I have been a keen observer of the tension inherent in our federal system of government between, on the one hand, the sovereign taxing authority of state and local governments and, on the other hand, fundamental American ideals of free–flowing interstate commerce. The advent of the Internet and the development of a truly global economy have only intensified that dynamic. I commend the Committee for exploring this important public policy issue which goes to core principles of the American constitutional system, and which has a real–world impact on America's ability to sustain its economic preeminence in the information age.

Our Federal System Requires Recognition of Jurisdictional Limitations on State Taxing Authority.

As to the question "How Much Do Borders Matter?: Tax Jurisdiction in the New Economy," it is my view that borders for purposes sales and use tax jurisdiction remain extremely important. Defining the appropriate reach of the sovereign authority of state and local governments is central to the American system of government. Indeed, the Constitutional Convention of 1787 was initially called to address the problem of individual state legislatures imposing taxes and duties on trade with other states, a practice which was pushing the young country into a depression. The solution devised by the Constitution's Framers was a federal system of dual national and state sovereignty, in which the Commerce Clause served, notably, to prevent state and local tax laws from hindering and suppressing the growth of interstate commerce. Needless to say, this plan has worked remarkably well for more than two hundred years.

The genius of our federal system of government is that each state is sovereign within its own borders and can adopt those tax and regulatory policies that best suit its particular needs and reflect the political preferences of its citizens. In this regard, each state is a separate and independent civic laboratory, where innovations in government programs and tax strategies can be tried out. If a chosen policy does not work well, only one state – and not the entire nation – is the subject of that experiment. If the voters object to how a certain policy initiative (for example, a new tax obligation) affects them, they have the ability to change that policy by electing new representatives. As a nation, we have benefited greatly from this federal structure of government.

In the area of state taxes, the federal system works especially well – so long as states respect the territorial limits of their sovereignty. Each state is free to craft how its

taxes are structured and administered within its own borders. A federal system permits, even invites, great variations in tax policy among the states. We certainly see that variety in the sales/use tax field. There are literally thousands of different sales and use tax jurisdictions in the United States. Of the 30,000 state and local jurisdictions with authority to impose sales and use taxes, more than 7,500 have adopted this kind of tax, and the number grows every year. These thousands of different jurisdictions generate an enormous variety of tax rates, taxable and exempt products, excluded transactions, filing requirements, audit arrangements and appeal procedures. The recognition of jurisdictional boundaries allows the American federal system to accommodate such numerous and varied exercises of state sovereignty.

Federalism does not work, however, when a state (or locality) attempts to export its tax system across state borders. At that point, the state is visiting its experiment on businesses that have no connection – or nexus – with the taxing state. Such an arrangement is not only chaotic as a matter of both tax administration and compliance (fifty state governments and thousands of localities imposing their myriad different tax systems on businesses in each of the forty–nine other states), but the out–of–state companies have no way to influence the very state tax burdens that are imposed on them. In the most real sense, this is "taxation without representation."

The Streamlined Sales Tax Project is, in many ways, a prime example of how the states struggle with our federal system of government. As with most governments, the states seek to maximize their taxation opportunities and leverage. It is always politically attractive to impose additional tax obligations on people who do not vote (e.g., imposing higher property taxes on vacation homes, higher sales tax rates on hotel lodging, meals,

and car rentals). This is constitutionally acceptable, so long as the target of the tax obligation is physically located within a state's borders. The temptation to impose tax burdens on non–resident companies may be irresistible, however, even if the state must reach beyond its borders to do so. At this juncture, however, the principles of federalism are clearly violated. Moreover, the adverse consequences are neither abstract nor theoretical, "taxation without borders" results in cost, complexity, confusion, and conflicts.

States could, of course, favor taxation over federalism by pressing Congress to adopt a single uniform national sales tax and distribute the proceeds among the states. Alternatively, states could agree on a truly uniform tax base, a single common tax rate, a single reporting and audit procedure, etc. These ideas have been suggested by law professors and tax policy academicians. The immediate response of the states to such proposals, however, is that such a coordination among states (and localities) would constitute a surrender of state sovereignty over state tax policy, and they are not willing even to consider the idea. The states cannot have it both ways. They cannot shout "sovereignty" and "state rights" when there are calls for real uniformity in state tax systems, and then turn around and argue that state borders should not restrict the scope and reach of state tax jurisdiction.

The Imposition of Limits on State Taxing Authority Remains Vital to the American Economy.

Of equal weight in Congress' consideration of this issue is the economic importance of setting territorial limits on the exercise of state and local tax jurisdiction. The United States Constitution – and the Commerce Clause in particular – has been the guardian of this country's open market economy. A central purpose of the Commerce

Clause was to prevent state taxation from hindering and suppressing the free flow of interstate commerce. More than 200 years before the establishment of the European Union, the Framers of the United States Constitution created a common market on this continent through the Commerce Clause, and their foresight powered the greatest economic engine the world has ever known.

As we move forward in the era of electronic commerce, it is imperative that public policy not impede its growth or hinder the ability of American companies to maintain their leadership position in this vital sector of the world's economy. Markets must remain open and accessible, and entry into those markets must not be restricted by disparate, confusing and parochial state tax laws that extend far beyond their jurisdictional borders. There has never been a time when it has been more important for Congress and the Supreme Court to support the original intent of the Commerce Clause, which was to create one national marketplace in which goods and services move freely.

Today, digital products and services can be delivered instantaneously and anonymously across vast distances, both within the U.S. and from beyond our shores. Consumer empowerment, instantaneous transactions, and open access are defining features of electronic commerce. Many states and localities have responded to this new economy by expanding their sales and use tax bases to include the taxation of digital goods and services. Unfortunately, some of these measures have saddled electronic commerce with tax and regulatory burdens designed for another era, and the adverse consequences are potentially dire.

The recent and encouraging rebound of the U.S. economy has been driven, in large part, by a rejuvenated technology sector, which would be negatively affected by

new tax burdens on electronic commerce. With high energy prices threatening the current economic recovery, now is not the time for the federal or state governments to throw a wet blanket on the Internet.

Expanding state and local tax jurisdiction would also imperil American competitiveness in the global electronic marketplace. Until recently, U.S. companies have been dominant in the field of electronic commerce. Increased foreign competition, however, means that American businesses, and their national government, cannot take for granted this leadership position. Expanding state jurisdiction to impose new tax collection obligations on domestic electronic merchants will have the effect of advantaging their foreign competitors, on whom state and local tax collection obligations could never be effectively imposed. Moreover, cumbersome and expensive tax burdens would inevitably drive emerging American Internet businesses to offshore locations.

The Streamlined Sales and Use Tax Agreement Has Not Adequately Reformed the System of State Sales and Use Taxes to Warrant Sacrificing Core American Constitutional and Economic Principles.

I hope that the members of this Committee recognize that legislation to expand state and local tax jurisdiction implicates vital public policy concerns regarding federalism and American competitiveness. Unrestricted state taxing jurisdiction is simply bad tax policy, because it would result in a nationwide transaction tax system of enormous complexity. More significantly, however, the proposals before the Senate to extend state tax jurisdiction beyond state borders undermine the principle of federalism on which the theory and vitality of American government rests, and such legislation would remove 200 years of constitutional protection of America's open marketplace. The Supreme Court has been vigilant in maintaining the principles of federalism mapped

out in the Constitution, especially as it relates to the Court's Commerce Clause jurisprudence. It would be unwise for Congress to accept the short–sighted invitation of state tax administrators to weaken the existing constitutional limitations on state taxing authority.

At a minimum, Congress should be insistent on setting the bar for state tax reform very high before removing constitutional restrictions on state tax jurisdiction. Elected leaders should be certain, before they surrender core constitutional and economic principles that have undergirded two centuries of prosperity, that the system they allow to replace it will protect and foster continued economic growth.

Unfortunately, the SSUTA falls far short of this standard. The Streamlined Sales and Use Tax Agreement, in its current form, is a misnomer. It does not achieve its professed objective of simplifying state taxes and, to the contrary, in many respects it worsens, and further complicates, the "crazy quilt" of differing state and local sales and use tax laws. Some of the most glaring shortcomings of the Streamlined Sales and Use Tax Agreement include:

- The failure to adopt the fundamental principle of "one rate per state" for all commerce, which would have eliminated the problem of merchant compliance with literally thousands of local tax jurisdictions;
- The failure to establish true uniformity of definitions with respect to taxable and exempt products;
- The failure to reduce, in any meaningful way, the burdens of tax collection, reporting, remittance and audits for interstate marketers;
- The SSTP's blind–faith in still unproven tax compliance software as the "silver bullet" that will solve the overwhelmingly complex tax compliance problems presented by the multi–state sales and use tax system described in the Agreement;

- The failure to consider the Agreement's impact on consumers ordering products by mail and paying for their purchases by check or money order, which especially affects America's older and less affluent population;
- The failure to guarantee fundamental fairness with respect to vendor compensation for tax collection;
- The failure to provide an effective and enforceable mechanism to assure continuing compliance with the Agreement by member states;
- The failure to afford out–of–state businesses with the right to challenge tax assessments that violate the Agreement before a fair and impartial federal tribunal; and
- The open willingness of states to "game the system," sacrificing simplification and uniformity in favor of protecting parochial state concerns.

The Shortcomings of the SSUTA Measured Against the Core Constitutional Values It Would Threaten.

To assist the Committee in understanding how much state borders for sales and use tax jurisdiction still matter in our federal system, and why the SSUTA does not render obsolete the essential constitutional objectives of the Commerce Clause, the answers to the following questions are intended to demonstrate the fundamental shortcomings of the SSUTA:

- **Is the Commerce Clause nothing more than a Constitutional loophole?**

Absolutely not. State tax administrators may complain bitterly about restrictions on their taxing authority because of Supreme Court cases such as *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), but the constitutional requirement that a company must have "substantial nexus" with a state before that state has the authority to impose tax obligations is consistent with the central tenet of the Commerce Clause to protect interstate commerce. Congress should be highly suspect of any argument that trivializes well–established Constitutional protections.

- **Do catalog companies and electronic merchants have an unfair advantage over traditional retail stores, including "big box" retailers?**

Not at all. First, let's be clear: sales and use taxes are consumption taxes, for which payment is ultimately due from the buyer. The issue in controversy is how states collect those taxes from their residents. The Supreme Court has consistently held that if a retailer is located within a state and benefits from state–provided services (e.g., police and fire protection, utility services, job training programs, etc.), it is reasonable for the state to require the in–state retailer to collect sales tax. On the other hand, where a company has no physical presence within a state and receives no benefits from state and local government services, it is improper for the state to delegate the tax collection responsibility to the out–of–state company. Instead, the state must collect any tax due directly from its residents.

Large "big box" retailers are regularly granted substantial tax breaks and incentives by states and localities, such as tax increment financing, to lure those companies to locate stores within the relevant jurisdiction. These are benefits that are not available to out-of-state merchants. For example, one large, well–known retail chain recently secured tax breaks of upwards of $40 to $50 million in each of several states where it proposes to open a store, an enormous tax advantage not available to remote sellers. In addition, non–tax advantages are heaped on large chain store retailers by states and localities in the form of municipal bond financing, infrastructure construction, and even the use of eminent domain. These are examples of public financial assistance enjoyed solely by in–state retailers.

Nor do catalogers and Internet vendors have a *competitive* advantage over retail stores because remote sellers are not obligated to collect sales/use tax. There are inherent

differences in the cost of doing business for in–state and out–of–state merchants that have much more of an impact on their relative competitiveness than does collection of sales tax–most obviously, an out–of–state vendor must recoup delivery costs through shipping and handling charges, usually in an amount considerably greater than the applicable use tax.

For these and other reasons, allegations of an "unlevel playing field" that favors catalog/Internet sellers over bricks–and–mortar retailers are distorted and misleading.

- **Is the Internet a threat or an opportunity for "Main Street" retailers?**

Unquestionably, it is an opportunity. Somewhat cynically, proponents of the SSUTA claim to champion local "Main Street" merchants who must collect sales tax on their over–the–counter sales. The real competition for "Main Street" shopkeepers comes not from out–of–state sellers, but from the large chains of "big box" stores that have emptied America's downtowns, while also garnering enormous tax and other public benefits from state and local governments. It is the Wal–Marts, Targets, and Costcos that have driven the traditional local department and hardware store out of business.

More significantly, there are countless stories of old line "Main Street" merchants, as well as local niche marketers, who have used the Internet to develop new markets for their goods across the country and around the world. It is hardly surprising that the retail giants are the main advocates for increased tax obligations on electronic merchants. These are the companies that would be the real beneficiaries of a tax system that imposes new tax and regulatory burdens on their Internet competitors.

- **Advocates for expanded state tax jurisdiction argue that most electronic commerce transactions avoid state taxes; is this true?**

No. The perception that electronic commerce is tax free is wildly inaccurate. The vast majority — by all accounts 85 to 90 percent — of electronic commerce is comprised of business–to–business ("B–to–B") transactions. Because companies typically self–report use tax, and are subject to periodic use tax audits by states and localities, most electronic commerce is subject to applicable sales and use taxes.

Furthermore, even as to business–to–consumer ("B–to–C") Internet transactions, the belief that most of those transactions are tax free is also inaccurate. There are many multi–channel retailers (i.e., retailers with both retail stores, Internet websites, and, in some cases, catalog operations) that collect sales/use tax on their Internet and other remote sales because they have nexus due to the presence of their stores throughout the country. Indeed, the perceived "problem" of catalog/Internet vendors not collecting use tax has proven to be largely self–correcting. As remote sellers grow, most of them embark on a multi–channel sales strategy, which includes opening retail stores. Thus, numerous catalog/Internet retailers have begun to collect state sales/use taxes voluntarily. In other words, recent history shows that successful Internet retailers will grow their businesses by adopting a parallel retail store strategy, and, upon doing so, commence sales and use tax collection on all sales (including Internet sales) to residents in states where the stores are located.

- **Have state governments overstated the amount of tax revenue they are losing as a result of current constitutional restrictions on their taxing power?**

Yes. State revenue departments' dire predictions of revenue "losses" resulting from allegedly untaxed e–commerce transactions have proven to be grossly exaggerated.

State tax administrators frequently cite a University of Tennessee study ("UT Study") conducted in 2000, and updated in 2001 and 2004, in support of such claims. The UT Study, even as updated, suffers from several flaws: (1) it does not sufficiently account for online B–to–B sales, most of which are either non–taxable sales for resale or are sales for which a use tax is generally reported directly to the state by the business purchaser; (2) it grossly overestimates the total amount of online B–to–C sales; (3) it fails properly to account for the portion of B–to–C commerce that is not subject to sales tax (principally sales of non–taxable services); (4) it underestimates the level of B–to–C sales on which sales tax is collected (such as online travel sales); and (5) it does not take account for the increase in tax collection by Internet sellers that also have retail stores. Indeed, Dr. Peter A. Johnson, a Senior Economist with the DMA, conducted an analysis in 2002–2003 based on actual Commerce Department data that showed how earlier, predicted "losses" in state revenue had not materialized.

- **Are there ways for states to collect use taxes directly from their residents (who are the persons liable for the tax) without imposing burdensome tax collection obligations on remote sellers?**

Yes. It is now common for states, from Maine to Louisiana to California, to include a section on individual state income tax returns for reporting use tax due on out–of–state purchases. This tax collection procedure is straightforward, simple to calculate, and inexpensive.

- **What is the current fiscal condition of the states? Are they suffering major shortfalls in state budgets?**

Quite the contrary. With the economy recovering, most states are benefiting from budget surpluses. For fiscal 2006, the Wall Street Journal reported that 37 states had revenues in excess of projections, 10 other states met their projections, and only 2 states

reported revenues below budget. Now is not the time for Congress to enact measures that will dampen the economic recovery, particularly in the crucial electronic commerce and technology sector, by extending burdensome state tax obligations. Indeed, somewhat ironically, state budgets would likely be one of the first victims of such federal legislation.

- **Just how complicated is the current system of state and local sales taxes in the United States?**

It is enormously complicated. There are over 7,500 jurisdictions in the United States imposing transaction taxes, and the number grows every year. Moreover, among these jurisdictions there is enormous disparity in rates, exemptions, filing requirements, etc. Local sales and use taxes appear in the form of municipal taxes, county taxes, school district taxes, transportation district taxes, sanitations district taxes, sports arena district taxes, and the list goes on. Moreover, the thousands of state and local jurisdictions frequently change their rates, exemptions, filing requirements, etc., so that they are literally a moving target in terms of vendor compliance. The recent phenomenon of short–term sales tax "holidays" — during which tax is suspended on some but not all products — adds a new dimension of complexity.

- **When the Streamlined Sales Tax Project started out in 2000, it set high goals for true simplification of state sales and use taxes; why did the states abandon their effort to achieve "high bar" reform of their tax systems?**

Building on the recommendations of two earlier joint government/industry projects (the National Tax Association Communications and Electronic Commerce Tax Project, and the Congressionally–established Advisory Commission on Electronic Commerce) whose mandate was to examine the measures necessary to simplify the

existing sales and use tax system, the Streamlined Sales Tax Project presented itself in 2000 as a bold initiative by state legislators and tax administrators to simplify, harmonize and modernize state and local sales and use tax laws. The shared understanding of tax administrators and retailers alike was that the existing system was one of daunting complexity, and that true simplification would require radical reform. In this spirit, the DMA contributed suggestions from the outset, setting forth in a letter to Project leaders in August 2000 a comprehensive list of reform proposals. The fate of the DMA's proposals in the SSTP process is telling, both with respect to the weight industry positions actually carried with the Project leaders and the states' failure in achieving their original goals. Of more than 30 specific reform proposals offered by the DMA, the Agreement approved by the states fully adopted only two (centralized registration and uniform bad debt provisions).

Unfortunately, the high ideals of SSTP organizers, which offered the promise of genuine and dramatic sales and use tax reform, were eroded by the political realities of having to gain the endorsement of state legislatures, municipal officials, and political constituencies. When the Project representatives were confronted with the difficult task of surrendering the unique features of their state and local tax systems, they repeatedly retreated from original proposals for dramatic tax reform and consistently rejected, or diluted, provisions that would have produced substantial uniformity among the states. The result is a "low bar" Agreement that contains only minor, and in many instances cosmetic, tax reform measures. Rather than a truly uniform system, the SSUTA perpetuates, and in many respects aggravates, a taxation system of tremendous complexity.

- **Did the SSUTA adopt the recommendation of both the E–Commerce Tax Project and the Congressional Advisory Commission that there should be only one sales and use tax rate per state?**

No. The SSUTA allows two state–level sales and use tax rates per state (the second rate is for food, food ingredients and drugs) and also allows every local jurisdiction to have its own separate rate. Both the E–Commerce Project and the Advisory Commission found that one rate per state for all commerce, i.e., no separate local tax rates, is an absolute requirement for any meaningful reform of state sales and use tax systems. The failure of the SSUTA to adopt the one rate per state principle substantially defeats the goal of simplification from the outset.

- **What has the SSUTA done to reduce the number of local tax jurisdictions, over 7,500 at last count?**

Nothing. Once again, this is a fundamental failing of the Agreement. Reduction in the number of taxing jurisdictions in the United States is the core requisite of sales/use tax reform. The Supreme Court in *Quill* (and in prior decisions), as well as joint government–industry groups that preceded the SSTP, recognized that the complexity of the existing system derives, in large measure, from the staggering number of local taxing jurisdictions. No limit on the ever–increasing number of local jurisdictions is contained in the SSUTA.

- **Does the SSUTA's so–called menu of definitions mean states have achieved substantial uniformity?**

No. Under the SSUTA, each state continues to determine which products and services are taxable and which are exempt from tax in that state. The SSUTA includes some "uniform" definitions, but the number of defined products and services is very limited. Furthermore, the Agreement permits a state to enact exemptions without

restriction if the Agreement "does not have a definition for the product or for a term that includes the product." Since the number of defined products and services is small, the taxability of given products and services from state to state continues to vary widely. As states increasingly move to impose transaction taxes on services, including services delivered electronically, the disparity in state tax bases will become even more pronounced.

Even as to those definitions contained in the Agreement, the SSUTA only requires that the state adopt definitions which are "in substantially the same language" and are "not contrary to the meaning of" the definitions contained in the Agreement. Every state is thus allowed to have its own "grey area" with respect to each term defined in the Agreement. Furthermore, many of the so–called "uniform" definitions crafted by the SSTP allow participating states to carve out a variety of sub–categories of products, creating endless possible variations from state to state.

- **Have the states at least agreed to a uniform method for consumers and businesses to compute the applicable sales tax for each state?**

No. The SSUTA's so–called "uniform" definition of the term "sales price" does not require member states to adopt a uniform measure of tax, but rather allows each state to include or exclude each of a number of different components, requiring sellers to track different definitions of "sales price" in every state.

- **Does the SSUTA minimize the number of audits by state revenue departments to which remote sellers will be subject?**

No, to the contrary, it increases them. The state representatives to the SSUTA rejected proposals for joint audits (*i.e.*, one audit conducted on behalf of all Member States). If state tax jurisdiction is expanded, a direct marketer selling to customers

throughout the country will need to file tax returns each month for all states (the SSUTA representatives also rejected a proposal for a single nationwide tax return), and they will be subject to audit by each one of those states. As a result, businesses will literally be under perpetual audit. Moreover, if a retailer disagrees with the outcome of such an audit, it will be required to pursue administrative and judicial appeals in a remote state, all at considerable expense.

- **The increasingly popular practice of state legislatures adopting sales tax "holidays" for short (several days) time periods introduces considerable complexity for catalog companies, who may feel compelled to explain in their catalogs the effect of those tax holidays on their customers' tax obligations. Does the SSUTA bar sales tax holidays?**

No. The Agreement allows states to continue to adopt sales tax holidays. To make matters worse, the Agreement allows states to establish "thresholds" during state tax holidays, so some items are exempt during the holiday only to the extent that the transaction exceeds a threshold item price or purchase amount. This can only add confusion on top of complexity.

- **Even if the SSUTA does not go far enough, must states at least conform strictly with the modest uniformity provisions of the Agreement?**

Sadly, the answer is no. Even with the watered–down standards of the SSUTA, i.e., "low bar" tax reform, the Agreement does not require strict compliance with those standards. For example, a member state is deemed to be in compliance with the Agreement if "the effect of its laws, rules, regulations and policies is substantially compliant with each of the requirements of the Agreement." Since only the overall "effect" of a state's tax policies is required to comply "substantially" with the Agreement, state tax regimes may vary from the specific terms of the Agreement in countless ways.

- **Critics also accuse SSUTA members of "bending the rules" to meet their own objectives? Is this true?**

Absolutely, and this practice should raise substantial concerns in Congress about approving a system whose administrators play "fast and loose" with their own standards. Let me offer three examples.

First, in order to become a member of the SSUTA, a state must conform its laws to the terms and requirements of the Agreement. In theory, this assures adequate uniformity among the member states (although, as I noted, the Agreement's conformity standard itself is weak). However, as SSUTA participants have readily acknowledged at public meetings, each state is allowed to determine *for itself* which of its tax laws will be made subject to the requirements of the Agreement. In other words, rather than extending the scope of the Agreement to all state and local transaction taxes, states are able unilaterally to decide that the Agreement applies only to those taxes they choose to denominate as "sales and use" taxes. Incredibly, state tax officials and SSUTA delegates have emphasized to skeptical state legislators considering SSUTA conformity legislation that the legislature can selectively exclude state taxes from the purview of the SSUTA, simply by not designating the tax a "sales" tax and by not submitting it for scrutiny by the SSUTA's Governing Board. In fact, every SSUTA member state has transaction taxes that it has unilaterally decided not to subject to SSUTA requirements.

Second, the Agreement, by its terms, was only to take effect when at least ten states comprising at least twenty percent of the total population of all states imposing a state sales tax were determined to be in conformity. SSUTA delegates were apparently so concerned in April 2005 that they would not secure membership of enough states to meet their self-imposed threshold, that they quickly adopted a new provision allowing for

so–called Associate Members, which are states that the Project participants acknowledge have not yet conformed their laws to the Agreement, but which states will, nonetheless, be counted toward the critical mass necessary for the SSUTA to become effective. State representatives to the SSUTA have publicly acknowledged that the provisions regarding Associate Members were adopted in haste, without careful consideration of all of the ramifications of creating this second class of members on other parts of the Agreement, in order to "meet the quota" necessary for the Agreement to take effect.

Third, the SSUTA Governing Board has recently determined that it is not required to expel from the Agreement an Associate Member, Utah, whose legislature in 2006 repealed a large number of laws which had originally been enacted to bring the state into SSUTA compliance. The repeal legislation clearly put that state out of compliance with multiple SSUTA requirements. Although no longer in compliance with the Agreement, Utah remains a member, accepting SSUTA vendor registrations, participating on SSUTA committees, and voting on matters with other Associate Member states.

If states are willing to compromise even the most fundamental SSUTA standards – those for determining conformity with the Agreement – how can Congress have any confidence that the SSUTA representatives will not bend other standards when domestic political pressures or bureaucratic preferences lead them to do so?

- **Have individual SSUTA Member States, in fact, avoided the uniformity requirements of the Agreement by simply re–naming non–complying taxes or using other legislative devices to "game the system"?**

Yes. For example, under prior law, Minnesota — a Full Member in the SSUTA — exempted most items of clothing, but imposed sales/use tax on fur coats. The SSUTA, however, requires that a state exemption must apply to an entire defined category of

goods, in this case clothing. Indeed, such categorization of taxable products is a much ballyhooed part of the Agreement. Because furs are deemed "clothing" under the Agreement, Minnesota would have been required to include fur coats in its sales tax exemption for clothing. Rather than conform its laws to the requirements of the SSUTA, the Minnesota Legislature simply enacted a new "special fur clothing tax," outside of its sales and use tax statutes. The Minnesota Department of Revenue then omitted the new "fur tax" from its SSUTA membership petition. The other SSUTA state representatives were well aware of this maneuver when voting to grant Minnesota Full Member status. They chose to ignore it.

Open approval of this sort of gamesmanship leads other states to follow suit. For example, the legislature in New Jersey, another "Full" SSUTA Member, has just enacted, effective July 15, 2006, its own version of the "fur tax." The New Jersey law creates a new gross receipts tax on fur clothing, because New Jersey could not, consistent with its membership status in the SSUTA, impose a sales tax on such apparel, because New Jersey otherwise exempts "clothing" (as defined in the SSUTA) from its sales tax. It is also worth noting that the New Jersey fur tax applies at a rate of 6 percent, although New Jersey just raised its general sales and use tax rate to 7 percent, so the fur tax arguably flaunts not only the definitional requirements of the SSUTA, but also the requirements that members have only one state–level sales tax rate (other than food and drugs).

Tennessee (an Associate Member) has engaged in similar legislative end–runs around the SSUTA requirements. Rather than conform to the requirements of a single state rate (for all items other than food and drugs), Tennessee adopted certain "special user privilege taxes" which impose disparate tax rates on the sale of select products and

services. Here again, the state simply renamed an existing tax to avoid application of the Agreement, rather than accepting the uniformity required under the SSUTA.

How can states talk about uniformity, and simplification of their tax systems, when "beating the rules" involves nothing more than creative name–changing? Clearly, states will resort to imposing "excise" and other "special" taxes on various items to avoid the conformity requirements of the SSUTA. Even worse, their brethren SSUTA states allow them to get away with it. Once Congress grants the states expanded tax jurisdiction, the incentive for state legislatures to yield to local pressures and evade uniformity strictures will only increase.

- **If Member States are already cheating (even while they are seeking congressional authority to expand their tax jurisdiction), is there an independent agency to oversee and enforce compliance?**

No. All matters of interpretation and compliance with the Agreement are decided by the SSUTA's Governing Board (a non–profit corporation, established under the laws of Indiana), which is made up of representatives of the SSUTA member states, who must be either state revenue officials, other executive branch representatives, or state legislators. In other words, the SSUTA is a system developed "by state tax administrators and for state tax administrators."

- **Even with its reduced, or "low bar," reform measures, have state legislatures been eager to conform their laws to the SSUTA?**

No. There are only 13 Full Member states in the SSUTA (recall that Associate Member states have not yet fully conformed their laws). Several state legislatures, including those in Florida, Virginia, Wisconsin, Maine, Hawaii and Washington have rejected conformity legislation. Numerous other state legislatures, including those in large states such as California, New York, Illinois and Pennsylvania, have not introduced

conformity bills for consideration. One SSUTA Associate Member state, Utah, has repealed many of the changes that were necessary to bring its laws into conformity with the Agreement. There is hardly consensus among state legislatures on the wisdom or merits of the SSUTA. Indeed, some state legislators have expressed skepticism about Congress involving itself with state tax systems. They are concerned that federal legislation could be a two–edged sword that restricts state tax prerogatives just as it expands state jurisdiction.

- **Advocates of the SSUTA claim that in the 21st Century computers are the answer to all the complexities associated with use tax collection. Is software an easy solution to the tax collection issue?**

No. Tax compliance software was to be the SSUTA's "silver bullet" to address the otherwise overwhelming complexities of differing state tax systems, but to this date there is no system yet proven, through actual use by a vendor, that accurately calculates and reports sales and use tax under the SSUTA. In fact, the SSUTA Governing Board — more than three and one–half years late — has only recently (as of June 1, 2006) approved the first software package it claims enables accurate collection for all SSUTA member states. There was, however, no independent testing or auditing of the third–party software approved by the Governing Board. Of course, software companies have claimed for years that they can accurately calculate and report sales tax for every jurisdiction, but retailers know that such systems have never reliably overcome the inordinate complexity of being integrated with their existing computer systems. System compatibility and scalability challenges present a real world hurdle to the use of the SSUTA's one approved software package. If this sole software system were made mandatory, hundreds of thousands of retailers in the United States would need to rely on

a single software provider. The vendor of this software readily admits that integration with legacy systems and software with which that vendor does not ordinarily interface makes integration difficult, if possible at all. The potential disruption to businesses would be substantial.

- **State tax administrators have proposed that third party intermediaries — so called Certified Service Providers — be responsible for tax collection, remittance and reporting. Is this a simple solution?**

No. The use of such intermediaries is a totally unproven experiment, and there is no basis for believing that this approach will be the answer to the daunting complexity of an unreformed tax system. The SSUTA Governing Board — again more than three and one–half years late — only recently (effective of June 1, 2006) approved the first two intermediary companies, and they have not yet begun providing the service to any retailer. As with software, there was no independent testing or auditing of the third–party systems approved by the Governing Board. The same compatibility, integration and scalability obstacles exist with respect to intermediary companies.

- **Doesn't the SSUTA require that states fully compensate retailers for the costs they incur in collecting use taxes?**

No. Clearly, expanded state tax jurisdiction would force retailers throughout the country to bear considerable additional expense to collect use taxes on behalf of states and localities. It is only fair that sellers should receive appropriate compensation. The SSUTA, however, contains no guarantees of fair compensation for these additional duties.

The Agreement vaguely provides that states "anticipate" establishing compensation measures for businesses, either intermediaries, retailers, or both, that incur compliance costs in connection with collecting and remitting use tax to the participating

states. The Agreement, however, contains no guarantees of compensation to retailers, and the states and intermediary companies do not yet know whether the compensation promised to the two approved intermediaries by the states will be adequate to cover their costs. But even the "anticipated" compensation does not extend beyond the first twenty–four months of a retailer's tax collection under the Agreement, although the retailer will obviously incur ongoing compliance costs. After the first two years, retailers are left to the whims of the individual member states, few of which currently provide a meaningful amount of vendor compensation, if they offer it at all. Moreover, once states have obtained congressional authority to impose use tax collection obligations on remote sellers, state legislatures will have every incentive to decrease, or eliminate altogether, the compensation they provide, in order to maximize state revenues.

- **Does the SSUTA deal with consumers who pay for their catalog purchases by check or money order?**

No. The Agreement ignores its impact on consumers (especially the elderly and persons with low incomes who cannot obtain credit cards) who, either by choice or necessity, order by mail and pay by check or money-order. The system envisioned by the SSUTA is unworkable where payment is made by check, and this problem is significant. According to the Federal Reserve, as of 2003, checks still accounted for 45 percent of all non–cash payments. Catalog customers paying by check must self–compute the applicable tax. In order to accommodate such customers under the SSUTA, a catalog would need to contain a tax table covering every state and local tax jurisdiction in order to (1) determine the appropriate tax rate; (2) inform the customer which products are taxable and which are exempt; and (3) alert customers to sales tax holiday periods. The likelihood for consumer frustration and error are obvious. Moreover, the Agreement

leaves the retailer liable for the tax even if the consumer errs in calculating it. This is not tax simplification.

- **Are some states using the SSUTA as an excuse to increase sales and use taxes?**

Yes. In fact, several provisions of the SSUTA will allow, or even require, states to increase their sales and use taxes when conforming their laws to the Agreement. The SSUTA limits states to one state tax rate, plus one additional rate for food and food ingredients and drugs. States that tax other products at a rate lower than the standard state rate will be required to either exempt such products altogether, which is not likely, or increase the tax rate on those products.

Member states that have (or formerly had) either caps or thresholds, or both, must eliminate them from state law (except in the context of a sales tax holiday) in order to conform to the Agreement. Some tax increases have already been enacted as a result. Tennessee had several thresholds for selected goods and services (from caskets to cable television) which exempted such items from tax on amounts below a specified threshold. Tennessee's conformity legislation provides for the repeal of at least some of these thresholds, subjecting its residents to new taxes. There will be many more examples of new taxes, or increased tax rates, resulting from adoption of the SSUTA.

- **If Congress authorizes the expansion of a state's tax jurisdiction to reach businesses in other states, will those business taxpayers be able to go to federal court to challenge tax assessments that violate their federal constitutional and statutory rights?**

No, and this is an issue of major concern. The sole arbiter of all disputes under the SSUTA is the Governing Board. If states, through federal legislation, are freed from existing constitutional limitations on the scope of their jurisdiction and are able to impose

tax collection obligations on companies located in other states, then those companies should have access to federal court to contest tax assessments that violate the provisions of the new federal legislation and, for that matter, any remaining constitutional protections such companies may have. Current federal law, however, bars taxpayers from going to federal court to challenge state tax assessments.

The Tax Injunction Act, 28 U.S.C. § 1341,[1] was enacted to permit states to administer their tax systems within their own borders without interference by federal courts. This rationale would no longer apply in the situation where states are enforcing their tax systems on sellers outside of their borders and pursuant to authority granted under federal legislation. Moreover, only federal courts can assure consistent interpretation and application of the SSUTA among all the states. Accordingly, any legislation that would override the existing constitutional restrictions on state taxing authority should be accompanied by a repeal of the Tax Injunction Act.

- **The SSUTA places enormous authority for interpreting the Agreement, hearing petitions and resolving disputes in an unelected Governing Board – do its rules and procedures meet fundamental standards of fairness and due process?**

So far, the Governing Board has been unresponsive to taxpayer requests for interpretation and complaints regarding state compliance. Moreover, the procedures and rules of the Governing Board and its committees remain unclear and their proceedings difficult to monitor. The delegation to the SSUTA from California, which is not a member state, but instead monitors the project through participation on the so-called State and Local Advisory Council (SLAC), recently wrote to the Governing Board to

[1] The Tax Injunction Act provides that "[t]he district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." 28 U.S.C. § 1341.

complain that meeting materials for the SLAC meetings were so consistently late in being distributed that the California delegation was not able to make such materials available to its citizens in a manner consistent with California sunshine laws. The California delegation indicated that it might have to withdraw its participation if the problem were not corrected, but SSUTA administrators informed the California representatives that no change in procedures was likely. Similarly, the Governing Board has an official website, but most sections of it are so seldom updated that it is not a reliable source of information for taxpayers on most matters. Put simply, SSUTA oversight responsibilities have been entrusted to state tax administrators who seek expanded powers from Congress, but who have demonstrated little discipline, responsiveness, or openness in the performance of their tasks.

Conclusion

Clearly, the SSUTA has numerous flaws in both its substance and implementation. Most significantly, the Agreement fails to address the key complexity of sales and use tax administration —thousands of tax jurisdictions and a multitude of tax rates. The early incidents of state legislatures circumventing the SSUTA conformity requirements, along with the Governing Board's unwillingness to do anything about it, should raise serious concerns in Congress. Is it reasonable to expect that state legislatures and state tax administrators will be more committed to conformity after Congress unleashes state tax systems from current constitutional restraints?

Most critically, it is important to remember what is at stake. Both the structure of federalism and the protective role of the Commerce Clause should not be lightly swept

aside. These are core constitutional values, and any argument for disregarding them should be compelling and urgent before Congress abandons these principles.

Thank you for giving me this opportunity to appear before you.

BRANN & ISAACSON

ATTORNEYS AND COUNSELORS AT LAW

184 MAIN STREET
P.O. BOX 3070
LEWISTON, MAINE 04243-3070
(207) 786-3566
TELECOPIER (207) 783-9325
E-MAIL ADDRESS: lawyers@brannlaw.com

IRVING ISAACSON
GEORGE S. ISAACSON
MARTIN I. EISENSTEIN
MARTHA E. GREENE
DAVID W. BERTONI
PETER D. LOWE
BENJAMIN W. LUND
DANIEL C. STOCKFORD
PETER J. BRANN
KEVIN R. HALEY

DANIEL A. NUZZI
MATTHEW P. SCHAEFER
SUSANNE F. PILGRIM
LYNN B. GELINAS
KEVIN J. BEAL
MAUREEN KEEGAN
REGAN M. HORNNEY
DAVID SWETNAM-BURLAND
BARBARA J. SLOTE
LAURA A. SHADLE

LOUIS J. BRANN 1948
PETER A. ISAACSON 1980

August 10, 2006

VIA FACSIMILE & U.S. MAIL
202-228-1703

The Honorable Charles E. Grassley, Chairman
Committee on Finance
United States Senate
Washington, DC 20510-6200

RE: Testimony before Senate Finance Committee
Subcommittee on International Trade
July 25, 2006

Dear Senator Grassley:

This letter is in response to the questions you forwarded to me from Senators Hatch and Bunning, members of the Subcommittee on International Trade, concerning my testimony before the Subcommittee on July 25, 2006:

Senator Hatch: *Mr. Isaacson, do you believe the Sales Tax Fairness and Simplification Tax, S. 2152, would be unconstitutional?*

Although Congress may have the authority under its Article I, Section 8 powers to enact S. 2152, doing so would run counter to the fundamental principles of federalism engrained in the Constitution and to the free and open market established by the Commerce Clause. A central premise of our federal system is that states are sovereign within their borders and do not have the power to impose burdens on commerce beyond their borders. In my view, the issue is not whether S. 2152 would survive a constitutional challenge in court, but whether Congress would, by enacting such legislation, upset the careful balance struck by the Constitution between the authority of states to design their own tax systems and the necessary limitation on each state's ability to export its tax laws beyond its geographical borders. I would hope that Congress, although possessing the power under the Commerce Clause to disturb that balance, would decline the invitation of the states to undermine an essential framework of the Constitution.

BRANN & ISAACSON
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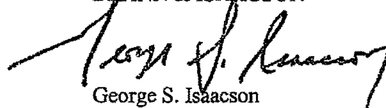
Senator Bunning: *Mr. Isaacson, in your written testimony, and in your remarks here today, you have stated that you feel the SSUTA is out of line with core principles of federalism and jeopardizes the protection for free-flowing interstate commerce. How serious are those concerns?*

The concerns I raise about federalism and protection of interstate commerce are very serious indeed. While these principles lie at the very foundation of our Constitution, because they impose restrictions upon the exercise of state sovereignty, state officials dismissively treat them as loopholes for avoiding state tax obligations, rather than as cornerstones of our national economy and federal system. Yet the importance of confining state authority within state geographical boundaries is fundamental. The objective of the Constitution in this regard was eloquently articulated by Chief Justice White a century ago: "[I]t would be impossible to permit the statutes of [a State] to operate beyond the jurisdiction of that State . . . without throwing down the constitutional barriers by which all the States are restricted within the orbits of their lawful authority and upon the preservation of which the Government under the Constitution depends. This is so obviously the necessary result of the Constitution that it has rarely been called in question . . ." New York Life Ins. Co. v. Head, 234 U.S. 149, 161 (1914). Such core constitutional considerations should not lightly be set aside.

Thank you again for the opportunity to address the Committee on this important issue. Please do not hesitate to contact me if you have any further questions.

Very truly yours,

BRANN & ISAACSON



George S. Isaacson

GSI/dmg

pc: Mark Micali

Testimony of

Douglas L. Lindholm, Esq.

President & Executive Director
Council On State Taxation (COST)
122 C Street NW, Suite 330
Washington, DC 20001
202/484-5222

On the Issue of

State Jurisdiction to Tax Business Activity

Before the

United States Senate
Committee on Finance
Subcommittee on International Trade

The Honorable Craig Thomas, Chairman

July 25, 2006

Mr. Chairman and Members of the Committee, I am Doug Lindholm, President and Executive Director for the Council On State Taxation, which is more commonly known as COST. I appreciate the opportunity to share with you COST's views on the important issue that you have before you—the appropriate extent of state jurisdiction to tax.

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of 585 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

In my testimony today, I hope to answer three questions:

- Why does the issue of Business Activity Tax (BAT) nexus warrant Congressional action?
- Why is physical presence the appropriate standard for BAT nexus?
- What impact would a physical presence standard have on State revenues?

BAT Nexus Needs Congressional Action

The first, and perhaps most important determination a business must make with regard to State business activity taxes is whether the business is actually subject to tax at all in a particular State. In other words, does the business have "nexus" with the state? This threshhold is governed by the U.S. Constitution's negative commerce clause, which prohibits states from unduly burdening interstate commerce. Taxing businesses with only limited links to a jurisdiction has long been considered a burden on interstate commerce because of the high compliance costs associated with the taxation of such fleeting or nominal activity. It is not an exaggeration to note that since the first state business activity tax was imposed, taxpayers have

never been certain as to what activities will subject them to the taxing jurisdiction of any particular state or local authority.

The United States Supreme Court has offered some guidance and at least one bright line rule as to the requisite level of activities sufficient to subject a business to a state's tax without creating an impermissible burden on interstate commerce. In its 1992 *Quill* decision, the U.S. Supreme Court reaffirmed an earlier holding from its *Bellas Hess* decision by reiterating its bright line rule that a State cannot impose a sales tax collection liability on a seller that does not have a physical presence in the State. From Congress' perspective, however, *Quill* was additionally a seminal refinement of the Court's earlier jurisprudence, because for the first time it noted a distinction in the concerns underlying the Due Process and Commerce clauses of the Constitution. As part of that distinction, the Court clarified that Congress may legislatively set the jurisdictional standard governing states' ability to impose tax burdens on interstate commerce. Indeed, the Court *invited* Congress to legislate in the area of nexus for state tax purposes, saying: "[O]ur decision is made easier by the fact that the underlying issue is not only one that Congress may be better qualified to resolve, but one that Congress has the ultimate power to resolve."

In the absence of Congressional action, however, states have become increasingly aggressive in attempting to assert tax jurisdiction over out-of-state businesses. These efforts to reach companies with a minimal or no presence in a state have led to litigation in state courts with mixed results—not unexpected given the lack of clear guidance from either the Congress or the U.S. Supreme Court. Conflicting state laws and court decisions create tremendous uncertainty and expense for taxpayers. Multistate businesses are deeply concerned both by this uncertainty and by state efforts to impose tax on businesses that do not have physical presence in a state, thereby burdening interstate commerce and limiting cost effective market options. Surveys of the

COST membership consistently demonstrate that this issue is the multistate business community's number one state tax policy concern.

The uncertainty created by conflicting interpretations of the Constitutional standard for tax jurisdiction has long resulted in unnecessary administrative and litigation expense for both taxpayers and states, and will certainly increase the costs and risks of operating a multistate business in the foreseeable future. For example, the recent Financial Accounting Standards Board Interpretation 48 (Accounting for Uncertainty in Income Tax) of its Statement 109 (Accounting for Income Taxes) shines a spotlight on the potential costs and market confusion associated with uncertain nexus standards. FASB Interpretation 48 appropriately seeks consistent treatment of uncertain income tax positions for financial statement reporting purposes. However, the lack of any national, definitive authority for state tax jurisdiction complicates the analysis under FASB Interpretation 48 and creates an ongoing dilemma for multistate companies. If a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence level ("more likely than not") on the validity of its financial statement reporting position under FASBI 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear from its financial statements unless the business is actually audited and the state determines it does not have nexus. This is but one example of how the current uncertainty over the scope of the nexus requirement creates confusion beyond the immediate tax effects.

Congress, accordingly, as the ultimate authority under the Commerce Clause, not only has the Constitutional duty to remedy the existing uncertainty, but serves as the measure of last resort for the courts and for multistate companies on this issue.

Physical Presence is the Appropriate Standard

It is COST's position that, in order for a State or locality to impose a business activity tax on a business, that business must have a physical presence in the jurisdiction. Congress must recognize physical presence as the jurisdictional standard for business activity taxes. Physical presence should be defined to include quantitative and qualitative de minimis thresholds. Congress must also prohibit unreasonable attribution of nexus. Finally, Congress must preserve and modernize P.L. 86-272. Legislation currently pending both in the Senate and the House of Representatives would accomplish all of these goals.

Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens—economic as well as administrative—only on businesses that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means that businesses that are not physically present in a jurisdiction and are therefore not receiving meaningful benefits or protections from the jurisdiction should not be required to pay tax to that jurisdiction.

Congress must exercise its authority under the Commerce Clause of the Constitution to recognize physical presence as the nexus standard for business activity taxes. In doing so, Congress should include de minimis thresholds based on the temporary presence of employees, agents and property in the State. Congress should also modernize P.L. 86-272 by including services and intangibles in its scope, extending its application to all direct taxes, extending its

coverage to activities subject to local taxes, and clarifying its definition of independent contractor.

Opponents of a physical presence nexus standard misconstrue both the burdens on business a lower threshold would invite and the global economy in which we now live. In prior testimony before the Senate on state tax jurisdiction, Elizabeth Harchenko, former Chair of the Multistate Tax Commission, argued that "sound economic policy requires the adoption of…economic nexus as the standard for the application of state and local taxes." Nothing could be further from the truth. No tax treaty to which the United States is a party recognizes such a low threshold for tax jurisdiction. What is economic nexus? Is it where a business has a customer? A website? An account receivable? Under an "economic nexus" theory, every company of any measurable size would be taxable in every state. Taken to an international level, every company would be taxable everywhere. Under an "economic nexus" theory, companies would lose any ability they currently have to support states that provide a favorable business tax climate, and states would lose any incentive to provide such an environment.

Indeed, some former tax administrators have recognized the problems inherent in an economic presence nexus standard. A former Multistate Tax Commission Executive Director, Eugene Corrigan, recently argued "that the states need to face the reality that most of them are generally incapable of enforcing the "doing business" [economic presence] standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general—and with mixed success, at best."

A Physical Presence Standard Would Minimally Impact State Revenues

COST retained Ernst & Young to estimate the fiscal impact of H.R. 1956, the "Business Activity Tax Simplification Act". [S.2721 is identical to HR 1956.] For all states, the estimated revenue loss is $434 million at the FY 2005 level of current-law state and local business tax collections. The revenue loss is 0.8 percent of the total state and local business activity taxes covered by H.R. 1956 ($54.4 billion), and compared to all state and local taxes paid by business in 2005, the revenue loss is less than one-tenth of one percent (0.1 percent).

Estimates of the fiscal impact of H.R. 1956 have varied widely. Estimating the expected impact of this complex bill on state and local business tax revenues presents revenue estimators with a formidable challenge. They must first determine which specific state and local taxes are affected by the bill and then identify which taxpayers in specific industries will no longer have nexus in a state. The final step is to estimate the change in tax payments for current taxpayers that no longer will be taxable in a state.

The biggest challenge for state revenue estimators is the fact that tax return information for current taxpayers does not provide sufficient information to identify these impacts with any degree of certainty. For example, while estimators may be able to identify taxpayers with no reported payroll and property in a state, there is no information on the return to identify what percentage of firms with "small" factors may no longer have nexus under the bill's de minimis thresholds for physical presence. In addition, in many states only a limited amount of information is actually "captured" in processing returns and available for analysis. Finally, there is no information available from tax returns that can be used to predict short- or long-run restructuring opportunities for taxpayers.

Given these data limitations, both private- and public-sector revenue estimators must make key assumptions in estimating expected revenue impacts. It is understandable that different

assumptions and estimating methodologies will result in an unusually wide range of revenue estimates for the bill. The range reflects both the limited amount of information available to estimators and important differences in assumptions about the taxes affected and how taxpayers will respond to the bill.

The very large variation in estimates of the impact of H.R. 1956 reported by CBO, NGA and E&Y is summarized in the table below.

Report	**Short-Run Impact**	**Long-Run Impact**
Congressional Budget Office (CBO)	$1 billion	$3 billion
National Governors Association (NGA)	$2.2 to $3.1 billion	$4.7 to $8 billion
Ernst & Young (E&Y)	$434 million	not estimated

The following points may help to understand why there is such a wide range of estimates across and within the studies:

- It is clear from the state survey responses used to prepare the NGA estimates that the states did not agree on their interpretations of the bill's provisions. For example, some states included excise taxes and certain gross receipts taxes that are not affected by H.R. 1956. This is due partly to the fact that the NGA estimates were based on early versions of the bill. The CBO and E&Y studies reflect the latest, amended version of H.R. 1956 that clarifies which taxes and activities are affected.
- The individual state estimates used in the NGA study differ significantly in their estimating methodologies and assumptions. For the states using tax model runs, there is wide variation in the minimum thresholds for payroll and property factors used to eliminate taxpayers assumed to have no physical presence. As a result of these differences, the short-run ("static") NGA tax losses, expressed as a percentage of business activity taxes, ranged from 0.0% to almost 40% for the 29 reporting

states. The CBO and E&Y estimates applied more uniform assumptions and estimating methodologies across the states.

- The impacts of the bill are very sensitive to the composition of industries in a state. However, only a few states in the NGA study estimated the tax impacts industry-by-industry. The E&Y estimates were done on an industry-by-industry, provision-by-provision basis for the 12 selected states.
- The NGA and CBO analyses overstate the *net* short-run revenue loss from H.R. 1956 by not including increased instate activities and income for instate firms, such as independent contractors, that perform functions for firms that would no longer have nexus in a state. In addition, it appears that the NGA estimating methodology did not account for the fact that the majority of separate-filing states have now adopted add-backs of expenses related to the use of intangibles, such as interest and royalty payments paid to out-of-state affiliates. These add-back provisions will reduce any revenue loss from the bill's extension of P.L. 86-272 protections to intangibles.
- A comparison of the short-run and long-run impact figures in the table shows how significant the restructuring assumptions are in the revenue estimates. For CBO, roughly 67 percent of the long-run tax impact is due to restructuring; the comparable figure for NGA is as high as 73 percent. Because there is no information on current tax returns to predict these behavioral changes, these long-run estimates are more speculative than the revenue estimates normally used in the state legislative process.

Conclusion

A properly constructed bright-line physical presence nexus standard will promote fairness, eliminate uncertainty for both businesses and states, and significantly reduce the frequency and costs of litigation. We are very interested in working with this Committee and other interested parties to articulate a bright-line physical presence nexus standard that is fair to both business and government. Mr. Chairman, I again thank you for the opportunity to speak before this Committee today. I welcome any questions that you or the Committee members may wish to pose.

Questions for the Record for
Mr. Douglas Lindholm
July 25, 2006

From Senator Hatch:

1. Mr. Lindholm, you mentioned in your testimony that states have become increasingly aggressive in attempting to assert tax jurisdiction over out-of-state businesses. Can you give us a couple of examples of this that you consider to be the most unwarranted?

From a behavioral standpoint, state tax administrators have every incentive to be as aggressive as possible in this area because it allows them to export portions of their tax burden to out-of-state companies whose employees, of course, don't vote in the state. Those same administrators have absolutely no incentive to recognize or acknowledge the impact their aggressiveness has on the free flow of interstate commerce, however.

As a result, states have sought to impose tax under a number of far-fetched theories, including the mere presence of credit cards carried in peoples' wallets in a state (*JC Penney National Bank v. TN*); the extension of a line of credit by an out-of-state company to borrowers in a state (*MBNA v. WV*); and the mere application for a certificate of authority to do business in the state (*Bandag Licensing v. TX*). In most of these cases , taxpayers ultimately prevailed after significant expenditures of time and money, although the uncertainty as to future exposure remains. Since the vast majority of tax issues are settled before ever reaching the litigation stage, there are dozens, perhaps hundreds, of other unwarranted aggressive tax jurisdiction assertions by the states that occur at the audit level but are never made public. Anecdotal evidence suggests that states have at least threatened asserting tax jurisdiction based solely or primarily on: an executive working in a state while on vacation; a telecommuter in the state working from home with minimal or no employer provided equipment; the taxpayer's physical presence in the state that ended prior to the period under review; and third party debt collector activities. Because state government tax attorneys are a fixed cost to the state, they have the luxury of trying novel nexus theories where the law is unsettled. In effect, they willingly throw theories against the wall to see which ones might stick, with great expense and uncertainty visited upon wary taxpayers.

A recently published nexus survey conducted by the Bureau of National Affairs (*2006 Survey of State Tax Departments*) shows that at least ten states are taking the position that their jurisdiction to impose business activity taxes extends to any business that merely has its telephone number listed in an in-state telephone directory; at least 13 states say that they can tax a company that owns electricity that merely flows through the state; at least 20 states say they will impose tax on a business that sends an employee into the state to check a job being completed by an independent in-state printer; at least 15 states say tax is due if the company's trucks are in the state (without even stopping) more than 12 times during the year; and at least 25 states claim jurisdiction to tax if a business files proof of a security interest in the state even though such an interest gives the holder

no current rights in any in-state property and will likely never result in the business having any such rights.

Ohio recently replaced its traditional franchise tax with a new Commercial Activity Tax. Any business that has customers or clients in that state that generate $500,000 in gross receipts is subject to that tax even though the business has never had an employee step foot in the state or owned a single piece of property in the state.

2. A complaint about business activity taxes is that they often are not accompanied by actual services provided by a state. Is there a way to discern whether an entity is receiving actual services from a state or locality without resorting to relying on the existence of a physical presence?

Not that we are specifically aware. Since the ultimate beneficiaries of government services – even in our relatively technologically advanced world – are people and their property, a business' physical presence in a jurisdiction (i.e., employees or property there) is still the best indication of when a business is part of a taxing jurisdiction's "society" and thus is appropriately subject to its taxing power. And, just as individuals pay taxes to their home state for services they may never specifically use (such as public education or the court system), so should businesses pay taxes for services they may never use, as long as they are part of the taxing jurisdiction's society; i.e., physically present there.

From Senator Bunning:

In addition to e-commerce, our economy has changed with respect to distribution of tangible goods from the manufacturer or producer to the consumer. In today's economy, companies increasingly rely on third-party warehouses for distribution of their products in interstate and foreign commerce. The finished product comes by truck or rail into the state from an out-of-state producer. It is temporarily held in a public warehouse for distribution to various locations. There is some concern about a state having tax jurisdiction over the out-of-state manufacturer of the product held in a public warehouse pending its distribution out of state. And yet, under S. 2721, as currently drafted, that would be the result. The bill says that if a company has property in a state for more than 21 days, there is tax nexus. In the case of product temporarily held in a public warehouse, this does not make sense to me.

The current version of S. 2721 provides an exception to the 21-day rule for product that is brought into the state to be assembled, processed, manufactured or tested by a third party for the benefit of the owner. Isn't product brought into the state and held for distribution by a third-party in a comparable position? Do you believe it would be advisable to add such an exception to the bill?

We would have no specific objection to including the ownership of goods in a public warehouse as an activity that would not, by itself, cause taxability. It is worthwhile to note, however, that there may be many circumstances where such goods are primarily intended for ultimate sale in the same jurisdiction as the warehouse. In such cases, the storage is directly related to the exploitation of the local market by the owner of the goods, and under H.R. 1956/S. 2721 would create a taxable nexus. This is in contrast to the activities the pending legislation currently excludes from the "21-day rule" because those activities are patronizing the local market -- not exploiting it.

From Senator Wyden:

1. For Panel III: Advocates for HR 1956/S 2721 say that the measure will simplify the determination whether a business has enough connection to a state to be obligated to pay tax. Wouldn't the factor presence nexus proposal discussed in Mr. Bucks' testimony provide simplicity with more consistency than these bills would provide?

The factor presence nexus proposal offered by the MTC still allows nexus to be predicated solely upon the location of *customers* in a state. Thus, a nexus determination could hinge on factors completely outside of a company's knowledge or control. In addition, applying the MTC's factor presence nexus standard in a real world context is exceedingly complex and problematic, particularly for large companies with numerous corporate entities. For example, in separate reporting states, the factor presence standard requires taxpayers to aggregate the factors of all commonly owned entities and file a joint information return based on "the unitary business grouping the taxpayer most commonly reports in states that require combined returns." Because the determination of a unitary group is based on specific facts and circumstances, many large companies have ongoing disputes regarding the composition of their unitary group in specific states. Due to variations in state laws and cases defining the unitary concept, these disputes will invariably continue, making such a nexus determination increasingly muddy, at best. Further, state "sourcing" rules – the rules for determining where a receipt actually occurs, vary drastically from state to state. To make matters worse, the MTC factor presence nexus standard imposes a new set of sourcing rules for determining which receipts are attributable to which state. Accordingly, companies would need to prepare a separate computation of their factors for each corporate entity – once under each state's specific sourcing rules, and once again under the MTC's factor presence nexus standard sourcing rules. For companies with hundreds of entities doing business in numerous states, this is a tremendous additional compliance burden.

The bright line offered by HR 1956/S. 2721 offers much more simplicity and nationwide consistency than the MTC's factor presence nexus standard. It is interesting to note that at four single-spaced pages, the MTC's proposal is longer than the entire Business Activity Tax Simplification Act.

2. *Do you think that if a company had a thousand persons in my state using company owned computers and driving company owned cars that the company had a physical presence in my state?*

While such a situation would certainly constitute a physical presence in your state, the nature of the persons' activities might not warrant taxation. For example, if those individuals were employed by a business in a neighboring state and were in your state to watch a professional sporting event as a "company outing," taxation would clearly be inappropriate. In the same vein, Congress decided in 1959 (under PL 86-272) to maintain the traditional rule that a business that merely has any number of sales people in a state does not warrant taxation (especially in light of the benefit to the American economy as a whole). In sum, the qualitative aspects as well as the magnitude of a business' presence is highly relevant.

3. *The Congressional Budget Office has concluded that, "By prohibiting state and local governments from taxing certain business activities, H.R. 1956 [companion bill to S. 2721] would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA)." What is your response to that?*

We do not disagree. There is a natural and healthy tension between the states' authority to tax and the authority of Congress to ensure the free flow of interstate commerce. Thus, if states are currently deriving revenue in a manner that is contrary to good tax policy (i.e., if taxes are being paid by those who derive no meaningful benefits or protections from the government to which they are paying taxes), or if certain actions by state taxing authorities are placing undue burdens on interstate commerce, then such revenues are clearly unwarranted.

4. *A Congressional Research Service study concluded that H.R. 1956 (and S.2721) would have the effect of "expanding the opportunities for [business] tax planning and thus tax avoidance and possibly evasion." Is the Congressional Research Service wrong?*

HR 1956 and S. 2721 make it clear that states will not be limited in their ability to address inappropriate tax planning in numerous ways. With respect to abusive tax avoidance and tax evasion, the states' current arsenal of common law and statutory weapons -- designed specifically to combat such abuse -- is unaffected. These include the step and sham transaction doctrines, business purpose and economic substance doctrines, section IRC 482 powers, arm's-length transaction standards, state add-back statutes, etc.

5. *The Council on State Taxation (COST)'s policy states that only physically present businesses should be subject to a Business Activity Tax (BAT) because only such businesses receive meaningful benefits from a state. But S. 2721 allows corporations to continue to have unlimited numbers of salespeople and delivery trucks loaded with goods in a state without creating nexus. Aren't those salespeople and trucks receiving police*

and fire protection and using the roads in the state? Don't they go about their business in reliance on a judicial system that operates on their behalf? Given these benefits that companies receive from states they sell goods and services in, why isn't it consistent with what you say is the fundamental principle underlying the bill to allow states to impose taxes based on their sales activities?

As noted above, Congress has already recognized, through the enactment of Public Law 86-272, that soliciting for sales and consequent shipping and delivery are activities that do not warrant taxation. Congress was merely codifying the traditional rule. Any revenue loss to a state where Congress prevents a state from imposing tax in such situations is mitigated or offset by the benefits to the American economy that results from free-flowing, unified interstate commerce.

6. Supporters of S. 2721 say that it establishes a "bright line physical presence" nexus standard. The Supreme Court's 1992 Quill decision purportedly did the same thing for sales taxes, but there's been constant sales tax nexus litigation in the states ever since. What's "bright line" about "physical presence"? Won't this lead to more litigation?

The Supreme Court's decision in *Quill* has, in fact, greatly reduced the amount of controversy and litigation in the sales tax arena. Prior to *Quill*, there was a great deal of debate over both what the appropriate nexus standard should be and what amount of that standard should be sufficient to establish nexus. Since the *Quill* decision set the standard at non-*de minimis* physical presence, most of the remaining debate has been how much presence is more than *de minimis*. H.R. 1956/S. 2721 would establish both the standard and the triggering quantity; consequently, controversy and litigation would necessarily be greatly reduced.

7. COST supports federal legislation that would reverse the Quill decision and allow states to impose their sales taxes on non-physically present businesses under certain conditions, including adoption of the Streamlined Sales Tax Agreement. If you agree that physical presence doesn't make sense as the nexus threshold for sales taxes, why does it make sense as the threshold for corporate income taxes?

The *Quill* case addresses the imposition of a sales tax *collection* duty, and *not* the direct imposition of a tax. We are supportive of federal legislation that would radically simplify state sales taxes to the extent that imposition of a sales tax collection duty on remote sellers would not be a burden on the free flow of interstate commerce. The federal sales tax streamlining legislation would also *compensate* remote sellers for their performance of the collection duty (essentially an administrative task) on behalf of state governments. Quite obviously, states are not planning to compensate taxpayers for their business activity tax payments in exchange for relaxing of the physical presence standard. The issue in the sales tax arena is whether the burden on a remote seller to collect and remit tax has been reduced sufficiently for Commerce Clause purposes; the actual sales tax burden, however, is borne by taxpayers (the purchasers) physically within the taxing jurisdiction.

8. COST apparently believes that making sales in a state, no matter how large, should never be sufficient to obligate a corporation to make income tax to that state. But many of your members have convinced the state legislatures to change state corporate tax law so that corporations are ONLY taxed in proportion to their sales in a state. Doesn't that mean that under S. 2721 most of their profits won't be taxed anywhere? How do you justify this? How could I and my colleagues in the Senate justify this to our voting taxpayers back home who would face an increased state tax burden as corporate tax revenues decline?

The two issues you describe, apportionment and nexus, are apples and oranges, and should not be compared. When a state legislature chooses to enact single sales factor apportionment, they do so to benefit their large in-state employers who have invested heavily in the state. Legislatures make this choice because of the benefits to the state that flow from such an incentive – including job retention and growth (and the concomitant increase in state personal income tax revenues), and to encourage additional investment of labor and capital, which also increases economic activity generally, thus increasing sales tax, property tax and other state tax revenues. State legislatures make this choice at the expense of out-of-state corporations, however, which then pay a higher burden of tax, since by definition they have relatively more sales than property or payroll in the state. These out of state companies are not happy with this change, but since they have little presence there, their only option is to seek a similar benefit in those states where they *have* invested heavily in labor and capital. Opponents argue that a physical presence standard allows that out-of-state company to avoid tax altogether by operating in that state through a third party or independent contractor. However, that third party or independent contractor would also see an increase in their business and profits – which of course would mitigate or offset the alleged decline in the out-of-state corporate tax burden. (An effect, incidentally, that is not captured in the fiscal estimates offered by either the CBO or the NGA). COST historically has taken no position with respect to state efforts to enact single factor apportionment incentives.

With respect to the nexus question, state tax administrators nationwide are aggressively pursuing their view of an unsettled area of law. As noted previously, such administrators have every incentive to bring in this "new money" from out-of-state corporations, yet have no incentive to evaluate whether their aggressiveness is harming the free flow of interstate commerce; that determination was expressly reserved for Congress through the Constitution's Commerce Clause. Accordingly, the uncertainty, expense and resources required to address the panoply of nexus issues make it entirely appropriate for Congress to legislate a bright-line physical presence standard in this area.

From Senator Schumer:

1. *In the Supreme Court decision in the Quill case, the Court decided that a physical presence standard makes sense in the case of the imposition of sales and use taxes. Can you explain why a different standard should be applied in the case of business activity taxes?*

As noted in an earlier answer, the Supreme Court's reasoning in *Quill,* -- forcing a remote business to comply with a plethora of greatly varying state and local tax rules would be an undue burden on interstate commerce -- applies equally to business activity taxes. With the latter taxes, however, the remote business would be faced not only with comparable administrative burdens but with actual economic burdens (the taxes themselves) as well. Consequently, perhaps the standard required before imposition of business activity taxes should be even greater than that for sales and use taxes.

2. *Mr. Lindholm, the estimates for state revenue losses under our BAT bill vary widely. Your group says that state revenue loss will be under $400 million. I think all of the estimates may be overstated for the following reason: Won't businesses that want to avoid double taxation respond to the status quo by declaring less income to their home states, thereby reducing the tax base?*

The study we commissioned through the economic experts at Ernst & Young concludes that for all states, the estimated revenue loss under HR 1956 is $434 million at the FY 2005 level of current-law state and local business tax collections. To put this in perspective, that amount is less than one tenth of one percent (0.1%) of all state and local taxes paid by business in 2005. With respect to behavioral responses by taxpayers to tax law changes, these are typically evaluated if such responses can be predicted with a reasonable degree of certainty. Given the uncertainty of predicting long run behavioral responses to HR 1956, however, E&Y did not include net losses related to such activity in the revenue estimates. States themselves acknowledged this difficulty in their responses to the legislation. The California FTB, addressing an earlier version of the bill, noted that "It is not possible to measure the impact of this federal bill for existing business practices in the state, let alone for opportunities presented to restructure operations in order to reduce or eliminate business nexus in California."

Thank you.

Testimony of

Michael F. Mundaca

Before the

Senate Committee on Finance

Subcommittee on International Trade

"How Much Should Borders Matter?: Tax Jurisdiction in the New Economy"

July 25, 2006

My name is Michael Mundaca and I am a principal in the international tax services group of the accounting firm of Ernst & Young here in Washington, DC. I want to thank Subcommittee Chairman Thomas, Senator Bingaman, and the other members of this subcommittee for inviting me to speak at this hearing today. I very much appreciate the opportunity to testify on this important topic.

Although many of our clients are of course are very interested in the issue of tax jurisdiction, I am not testifying on behalf of any clients or on behalf of Ernst & Young. The views expressed here are my own.

My testimony will be focus primarily on international tax jurisdictional issues, in accord with my background. Prior to joining Ernst & Young in 2002, I was the Deputy International Tax Counsel in the Treasury Department's Office of Tax Policy, in addition to being Tax Policy's Senior Advisor on Electronic Commerce. While at Treasury, I represented the United States at meetings of the Organization for Economic Cooperation and Development (OECD) regarding electronic commerce tax policy, and participated in the work of the OECD's Technical Advisory Groups regarding both direct and indirect taxation of electronic commerce. I also participated in drafting the OECD Model Treaty commentary regarding electronic commerce, including commentary regarding permanent establishment issues. In addition, while at Treasury I worked on matters relating to the Internet Tax Freedom Act, and was a Treasury staffer on the

Congressional Advisory Commission on Electronic Commerce. Finally, I have also been an adjunct professor at the Georgetown University Law Center, teaching a seminar on U.S. income tax treaties.

I would like this morning to discuss the current U.S. federal income tax jurisdictional rules, with particular emphasis on the rules contained in various income tax treaties, as well as discuss the application and development of those rules with respect to transactions in the new economy. I hope this discussion might provide some insights for the discussion of the income tax jurisdictional rules that should apply to the U.S. states. In addition, I would like to address briefly some possible international effects of expanded state income tax jurisdiction, with reference to some prior disputes.

Background – US Federal Income Tax Jurisdiction

U.S. Trade or Business

In general, under the Internal Revenue Code ("Code"), a foreign corporation is subject to U.S. income tax on income that is effectively connected with a U.S. trade or business. That is, a foreign corporation must meet two requirements to be subject to U.S. income tax under the Code on its business income. First, the corporation must be engaged in a U.S. trade or business; second, the corporation must earn income effectively connected with that U.S. trade or business.

The Code does not provide a comprehensive definition of a "U.S. trade or business," but provides merely that a U.S. trade or business generally includes the performance of services within the United States, but generally does not include certain stock, securities, or commodities trading. As a result of this lack of a comprehensive statutory definition, the analysis of whether a foreign corporation is engaged in a U.S. trade or business consists primarily in applying case law and administrative guidance to the underlying facts and circumstances regarding the corporation's economic activities in the United States.

Courts and the IRS have generally held that profit-oriented activities in the United States amount to a trade or business if the activities are regular, substantial, and continuous. Incidental or sporadic activities generally do not rise to the level of a trade or business. There does not appear, however, to be any explicit requirement of physical presence of the foreign person in the United States in order for a trade or business to be found.

In addition, it is not always clear what level and type of activities give rise to a U.S. trade or business. For instance the Tax Court has held that the delivering merchandise into the United States and maintaining a U.S. office to receive payments, without the solicitation or negotiation of the terms of the orders, is not sufficient activity in the United States to constitute a trade or business, because all true profit generating activity occurred outside the United States. In contrast, the Tax Court has also held that a Canadian sole proprietor who manufactured postcards in Canada was engaged in a U.S. trade or business because of his relationship with a U.S. distributor through which the postcards were sold. Similarly, the IRS has determined that a foreign corporation was engaged in a U.S. trade or business by virtue of the U.S. activities of its exclusive U.S. distributor.

In the context of the new economy, the application of these rules to, for example, cross-border sales over the Internet and the delivery of services over the Internet, is even more uncertain, in part because the U.S. trade or business rules have no explicit requirement of physical presence.

U.S. Tax Treaties

In contrast to the U.S. trade or business jurisdictional rules of the Internal Revenue Code, U.S. tax treaties use the "U.S. permanent establishment" concept to determine the limits of U.S. taxation of business income, and those limits are based on substantial physical presence. If a foreign person is eligible for treaty benefits, that person may choose to apply the treaty in lieu of applying the rules of the Internal Revenue Code. Under our treaties, the business profits of foreign persons eligible to claim treaty benefits are taxable by the United States only if the foreign person has a U.S. permanent establishment (PE) and only if the business profits are properly attributable

to the PE. The PE concept is found in every one of the more than 60 U.S. income tax treaties, as well as in most of the literally thousands of bilateral tax treaties in force between countries around the globe.

The PE concept originated in the work of the League of Nations, in the 1920s, spurred in part by efforts of some governments to levy income tax on foreign corporations that simply had customers in their country. Concerned with this expanding jurisdiction over business income, the League of Nations adopted the PE concept as a safeguard. That is, the League recommended that countries agree bilaterally to impose income tax on the business income of a foreign corporation only if the foreign corporation had a substantial physical presence in their country.

While the PE concept and provisions have developed somewhat over the last 80 years, they have retained their firm grounding in physical presence.

Before I turn to some of the issues regarding the application of the PE rules to transactions in the new economy, I should take a moment to explain the PE rules more fully.

Most tax treaties currently in force are based on one of three model treaties: the United Nations model, the U.S. model, or the OECD model. With respect to determining the taxing jurisdiction of business profits, all three models incorporate the PE concept, and there are only minor variations among the three. I will describe the OECD model PE provision, as that provision is probably the most widely used, and differs only in very minor respects from the provision in the U.S. model. In addition, the OECD provision has been the subject of recent review regarding its application in the new economy, as I will discuss shortly.

Under the OECD model provision, the business profits of a non-resident enterprise are taxable in the source state only to the extent the business profits are attributable to a permanent establishment. The model treaty generally defines a PE as a "fixed place of

business through which the business of an enterprise is wholly or partly carried on," including, but not limited to, a place of management, a branch, an office, a factory, a workshop, or a mine, quarry, or oil or gas well. Thus, to reiterate, in general, a physical presence in the form of a fixed place of business is required before tax jurisdiction may be asserted.

Moreover, because the place of business must be "fixed" in order to be a PE, temporary places of business do not give rise to PE. According to the OECD, PEs normally have *not* been considered to exist in situations where a business has been carried on through a place of business maintained for less than six months. In a special rule included in the OECD (and U.S.) model, a building site or construction or installation project constitutes a PE only if it lasts longer than 12 months.

The model treaty also includes a list of certain "preparatory or auxiliary" activities that will *not* constitute a PE, even if conducted through a fixed place of business. Such activities include the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise, as well as the maintenance of a stock of goods or merchandise solely for the purpose of storage, display, or delivery. Thus, for example, under the OECD model (and US model) PE provisions, a foreign corporation could remotely solicit and conclude orders with U.S. customers (e.g., by mail or over the Internet) and fulfill those orders from a stock of goods maintained in a facility in the United States and not be subject to U.S. income tax with respect to the profits from the sales, because the foreign corporation would not be deemed to have a PE in the United States.

There is one potential exception to the fixed place of business requirement of the PE rules: if a foreign corporation has an agent in a jurisdiction and that agent has, and habitually exercises, an authority to conclude contracts in the name of the corporation, then if the agent is not independent of the foreign corporation, the agent will create PE, regardless of whether the agent has a fixed place in business.

Thus, in general, the PE provisions of the OECD model (as well as those of the U.S. and UN models) require substantial physical presence before taxing jurisdiction may be asserted. Moreover, through the "preparatory and auxiliary" rules, the construction site rules, and the ordinary rules of application, certain fixed places of business that constitute substantial physical presence are nevertheless deemed *not* to be PEs.

Appropriateness of the PE Rules in the New Economy

Obviously, much has changed in the global economy and in business practices since the development of the PE concept in the 1920s, and some have questioned whether a tax jurisdiction concept so reliant on physical presence makes sense in an economy that is now so much more driven by services and intangibles than it was 80 years ago, especially as so much value can now through new technologies be developed and delivered at a distance.

It was just these sorts of questions, as well as other more practical and administrative questions, that prompted the United States, the OECD, and others in 1996 to begin to consider both the application of the current PE rules to new business models as well as consider whether the current PE rules should be substantially changed in response to new business models.

I participated in the OECD discussions and negotiations as a member of the Treasury Department. The position of the Administration at that time was that the current Treaty rules, including the PE jurisdictional rules, could be adapted to deal with new business models, and did not need to be abandoned or substantially changed. That was not the position of all the members of the OECD. Nevertheless, after literally years of study, discussion, and consultation, in late 2000, the OECD was able to release consensus changes to the official interpretation of the PE rules as applied to certain electronic commerce business activities which maintained the rules' strong reliance on physical presence. I think it is fair to say that those adaptations so far have proven to work well,

and have provided revenue agencies and taxpayers a set of reasonable and certain rules that are relatively easy to apply and administer.

That is not to say, however, that there does not continue to be dissent and calls for change. Spain and Portugal, for example, did not join the OECD consensus position, and have pressed the OECD to take up the larger project of assessing whether the PE rules should be fundamentally changed, in light of new technologies and new business models. And countries outside the OECD as well have been pushing for a re-evaluation of the PE standard, in addition to applying the current standard quite expansively.

So what are the arguments in favor of a new standard that moves away from reliance on physical presence? It is difficult to deny that the global economy, business models, and technology have changed over the last 80 years in ways that bear directly on the theoretical and practical justifications for basing income tax jurisdiction on physical presence. For example, the connection between the physical location of business activities and the physical location of the customer or other sources of business income has become increasingly attenuated. In addition, more and more goods, and more and more value, in the new economy are intangible and therefore not clearly located in any particular physical location.

Nevertheless, strong arguments remain for keeping the PE physical presence standard. An almost universal consensus has been achieved regarding use of the PE standard to determine income tax jurisdiction. This has created much needed uniformity, predictability, and certainty for multinational corporations and other taxpayers. Moreover, the consensus around the standard helps to mitigate double taxation and prevent tax jurisdictional disputes, which is especially important in a global economy. Finally, the rule prevents the administrative burden for multinational corporations and other taxpayers of having to file net basis income tax returns in every jurisdiction in which they have customers or other sources of business income. And as we discovered in the OECD process I just discussed, gaining a global consensus around a new standard would be difficult, if not impossible.

Federal Law Limits on State Income Tax Jurisdiction

Now, I'd like to turn briefly to the interaction of the federal income tax jurisdictional rules I just discussed with state income tax jurisdictional rules. That is, do the PE rules in our tax treaties that I just described impose any limits on the U.S. states' ability to impose income taxes? The short answer is, no they do not. By their terms, U.S. income tax treaties do not in general apply to state and local taxes. Thus, the PE rules I just discussed do not apply to limit the application of state and local income taxes, and therefore it is possible that a foreign corporation may be exempt from income taxation on the federal level because they have no physical presence in the United States, but may nevertheless be subject to state income taxation.

The issue of federal limits on state taxing powers has been the subject of litigation, and the Supreme Court has spoken regarding the international interactions as recently as 1994. In *Barclays Bank PLC v. Franchise Tax Board*, 512 US 298 (1994), the Supreme Court held that California's requirement of worldwide combined reporting for income tax purposes was constitutional even when applied to foreign corporations. One key to the Court's determination was that U.S. tax treaties, which provide for a different taxing standard than did California, do not generally cover state taxes, which the Court took to be an implicit grant of authority to the states to impose potentially contrary tax rules. In addition, the Court noted that the Senate had rejected a provision in a proposed income tax treaty with the United Kingdom that would have imposed a limit on state taxation, which the Court took to be an explicit determination that the states need not follow treaty rules.

Interestingly, although California's worldwide combined reporting tax system was validated by the Supreme Court in *Barclays*, California had by the time of the *Barclays* decision allowed taxpayers an election to limit application of its worldwide system (by allowing a so-called "water's edge" election). That change was made in response to threats by foreign corporations to take their business elsewhere, as well as to the threat

of federal legislation restricting the use of worldwide apportionment, which was itself prompted by complaints from foreign governments.

International Implications of State Taxing Decisions

The *Barclays* case is interesting not only because it illustrates the limited effect of tax treaties on state tax authority, but also because it illustrates the potential reaction of foreign corporations and foreign governments to expansive state taxation. Coupled with the already increasing pressure on the PE standard from countries that view the rules as inadequate and antiquated, assertions of expansive tax jurisdictions by the U.S. states could not only prompt protests by foreign corporations and foreign governments, but could also encourage foreign countries and international organizations to re-evaluate the PE standard and potentially replace it with an economic nexus standard. We have already seen a move by the European Union in the context of value-added taxes to place tax collection obligations on corporations that have customers but no physical presence in the EU.

Conclusion

To conclude, our experiences in the international tax area using the well-established PE concept have demonstrated that, for the most part, a clear physical presence standard is an appropriate basis for determining tax jurisdiction. As I have said, the international consensus regarding use of the PE concept has created needed uniformity, predictability, and certainty for multinational corporations and other taxpayers. It has helped to mitigate double taxation and prevent tax jurisdictional disputes. In addition, it has alleviated the administrative burden that would be imposed on multinationals if they were forced to file net basis income tax returns in every jurisdiction in which they have customers or other sources of business income.

Multistate taxpayers—and state revenue agencies—likewise could benefit from a similarly clear, consensus standard. There is no argument that our economy has

changed and that our tax rules need to reflect those changes. Similarly, however, there should be no argument that we should strive for uniform, predictable, and clear jurisdictional rules that minimize double taxation and that are easy to comply with and administer.

Thank you for the opportunity to testify. I would be happy to answer any questions you may have.

July 25, 2006

Estimates of Impact of H.R. 1956 on
State and Local Business Tax Collections

Prepared by Ernst & Young LLP
for
The Council On State Taxation (COST)

Overview

The Business Activity Tax Simplification Act of 2005 (H.R. 1956) establishes a bright-line physical presence nexus standard for a number of state and local business activity taxes imposed on multistate firms. Business activity taxes identified in the bill include corporate net income taxes, as well as other direct taxes based on business activities conducted in a state, such as franchise, net worth, gross receipts, single business, and certain license taxes.

The Council On State Taxation (COST) asked Ernst & Young's Quantitative Economics and Statistics practice to estimate the expected impact of H.R. 1956 on state and local business tax collections. This paper presents the results of the study and includes appendices that describe the provisions of H.R. 1956 and the methodology used in deriving the impact estimates.

Summary of Results

Table 1 presents estimates of the expected loss in state and local tax collections from the adoption of H.R. 1956. Ernst & Young (E&Y) prepared detailed estimates of state-by-state impacts of the bill for the twelve states reported in Table 1. The states were chosen based on total state and local business tax collections and the significant features of a state's tax system, including types of taxes, state income tax filing options, apportionment formulas and other tax system parameters.[1] As explained below, the insights gained from the detailed modeling of the impacts for the included states are then used to extrapolate the results to all states.

As shown in the first column of Table 1, the provisions of H.R. 1956 are expected to apply to a total of $54.4 billion in state and local taxes collected in FY 2005. The taxes that may be affected by H.R. 1956 include corporate income taxes, gross receipts taxes, franchise taxes, and other business activity taxes. This total includes both state and local business activity taxes.[2]

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[1] Michigan and Washington are included in the list of twelve states due to their unique business tax structures. Michigan imposes a modified value-added state business tax and Washington relies heavily on a state gross receipts tax. H.R. 1956 will affect these states differently from the more typical states that rely primarily on corporate net income taxes.

[2] The $54.4 billion of business activity taxes that could potentially be affected by the proposed bill is comparable to the $57.7 billion estimate presented in the National Governors Association (NGA) analysis, "Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States," September 26, 2005. The composition differs, however. The E&Y total includes more local taxes and excludes taxes included in the NGA study that would not be affected by the bill, such as personal income taxes and sales taxes in a few states. It should be noted that the Ohio corporate franchise tax is being phased out over a 5-year period; the loss estimate is for the current system. In

The second set of columns shows that an estimated 2.1 percent of this total, $1,158 million, is paid by firms that have no instate establishments.[3] These are the taxes paid by multistate firms that may have nexus in a state under current law -- due to the physical presence of employees, contractors or tangible personal property located in a state or sales into a state -- but do not have a plant, store, office building or other structure ("establishment") in the state.

Table 1
Estimates of the State and Local Business Tax Impacts of H.R. 1956
(amounts in millions, fiscal year 2005 levels)

State	FY05 Total Business Taxes Subject to H.R. 1956	Business Taxes Paid by Firms without Instate Establishments		Estimated Tax Loss from H.R. 1956		Tax Loss as % of Total Business Taxes
		$ Amount	% of Total Business Taxes	$ Amount	% of Taxes Paid by Firms without Instate Estab.	
California	$8,678	$158	1.8%	$42	26.6%	0.48%
Florida	$3,948	$57	1.4%	$20	35.1%	0.50%
Georgia	$537	$6	1.1%	$2	30.8%	0.35%
Michigan	$2,301	$71	3.1%	$26	36.1%	1.12%
Minnesota	$589	$18	3.1%	$7	38.7%	1.19%
New Jersey	$2,791	$76	2.7%	$29	37.4%	1.02%
New York	$5,339	$129	2.4%	$35	27.1%	0.65%
Ohio	$1,904	$38	2.0%	$10	27.7%	0.55%
South Carolina	$224	$2	1.0%	$1	33.3%	0.34%
Texas	$2,731	$68	2.5%	$20	29.1%	0.73%
Virginia	$996	$15	1.5%	$3	21.0%	0.32%
Washington	$3,544	$95	2.7%	$34	36.3%	0.97%
12-State Total	$33,581	$734	2.2%	$229	31.2%	0.68%
Rest-of-States	$20,797	$424	2.0%	$205	48.4%	0.99%
Total All States	$54,378	$1,158	2.1%	**$434**	37.5%	**0.80%**

The $1,158 million figure could be viewed as a maximum revenue loss, based on the current distribution of economic activity across the states and current state and local tax laws. However, only a portion of this amount would be lost as a result of H.R. 1956. Tax liabilities would be reduced only for businesses that have levels of physical presence, specified in the bill, that fall

addition, the impact estimates for Texas reflect the current franchise tax, not the revised franchise tax based on taxable margin that first applies to business activity in 2007.

[3] An establishment is defined by the U.S. Census as a business or industrial unit at a single physical location which produces or distributes goods or performs services.

below the bill's *de minimis* protections or are attributable to activities specified in the bill. (See Appendix A for a detailed description of these provisions.) For example, if the only physical presence an out-of-state equipment manufacturer has in a state is having employees temporarily in the state to provide repair services, the firm would continue to have nexus under H.R. 1956 if it has one or more employees in the state on 22 or more days a year. A revenue loss would only occur in this case if the manufacturer's employees are currently in the state less than 22 days but more than the state's current *de minimis* number of allowed days before nexus is established.

The third set of columns in Table 1 presents the estimates of the actual state and local tax loss expected from H.R. 1956.[4] *For all states, the estimated revenue loss is $434 million at the FY 2005 level of current-law state and local business tax collections.* The revenue loss is 0.8 percent of the total state and local business activity taxes covered by H.R. 1956 ($54.4 billion). Compared to all state and local taxes paid by business in 2005, the revenue loss is less than one-tenth of one percent (0.1 percent).[5]

As shown in Table 1, the business tax loss for the twelve states examined in detail is $229 million in FY 2005. California accounts for $42 million of the loss, while New York accounts for $35 million.[6] At the other end of the distribution, there are three states with losses of $3 million or less. For the twelve states, the loss in revenue varies from 0.32 percent of business activity taxes in Virginia to 1.19 percent in Minnesota. The twelve states account for 62 percent of the business activity taxes collected by all states.

To extrapolate the $229 million twelve-state loss figure to all states, ratios of estimated tax loss to total business activity taxes for the twelve examined states were applied to the total business activity tax estimates in the remaining states. Different ratios were used for separate filing states and combined reporting states. In addition, the ratios were adjusted to recognize the differences in corporate income tax nexus and sourcing rules.[7] The estimated loss for the rest of the states is $205 million. As shown in the last line of Table 1, the total loss for all states is $434 million.

Further insights into the expected state and local business tax impacts of H.R. 1956 are provided in Table 2. The table presents estimates of the distribution of business tax reductions by specific provisions of the bill for the twelve states. For business taxpayers in all industries, 27 percent of the revenue loss is due to the non-employee physical presence provisions. The employee activity and modifications of P.L. 86-272 provisions each account for 24 to 26 percent; the remainder of the loss is spread over the remaining two provisions. The last line of Table 2 presents the distribution of the total $434 million loss for all states by four major industry groups. Business

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[4] As explained in more detail in Appendix B, the estimates of the percentage of total state and local taxes paid by firms with no instate establishments that would be eliminated by H.R. 1956 is based on a section-by-section analysis of the bill's provisions for each of the twelve states studied in detail.

[5] Businesses paid an estimated $497 billion in total state and local taxes in fiscal year 2005. See *Total State and Local Business Taxes: Nationally 1980-2005, by State 2002-2005, and by Industry 2005* (March 2006). This study was prepared by Ernst & Young LLP in conjunction with the Council on State Taxation.

[6] The relatively high level of tax loss in New York is partly due to the level of local business taxes, including New York City.

[7] The results show that the tax loss, per dollar of business activity taxes potentially affected by the bill, is higher for the other states not included in the 12-state group. This partly reflects the fact that a greater share of the taxes collected in the other state group comes from separate-filing corporate income tax states. The estimates for the included 12 states indicate that the tax loss is greater, relative to the level of economic activity, in separate filing states compared to combined reporting states.

taxpayers in the manufacturing sector account for the largest share of the revenue loss, 34.4 percent, followed by services at 31.9 percent.[8]

Table 2
Distribution of Tax Impacts by Industry and Provision of H.R. 1956
(amounts in millions, fiscal year 2005 levels)

Categories	Industry Groups					
					Total	
	Manufacturing	Trade	Services	Other	Amount	% Distribution
12-State Totals						
Current Taxes (FY 2005)						
Total Business Taxes Subject to H.R. 1956	$5,628	$6,110	$13,981	$7,863	$33,581	
Taxes Paid by Firms without Instate Establishments	$284	$94	$223	$133	$734	
Provisions of H.R. 1956						
Physical Presence Requirement	$1	$3	$9	$6	$19	8.4%
Employee Activities	$18	$7	$19	$11	$55	24.1%
Non-employees Activities	$24	$9	$18	$10	$62	27.0%
Real and Personal Property	$23	$5	$4	$3	$35	15.0%
Modification of P.L. 86-272	$10	$7	$20	$22	$58	25.5%
12-State Loss	$76	$32	$70	$51	$229	100.0%
Rest-of-States Loss	$74	$13	$68	$50	$205	
Total Loss All States	**$149**	**$45**	**$138**	**$101**	**$434**	
Percent Distribution	34.4%	10.3%	31.9%	23.3%	100.0%	

The Issue of Restructuring and Long-Run Impacts

The estimates of the state and local revenue impacts of H.R. 1956 reported in Tables 1 and 2 are based on current law and estimates of the current level of economic activities in a state.[9] This is the standard approach to estimating the revenue impacts of proposed tax changes at the state level. It is also standard practice to include behavioral responses by taxpayers to tax law changes if the responses can be predicted with some degree of certainty, such as a reduction in fuel consumption in response to an increase in excise taxes on gasoline. Behavioral responses to tax

[8] The services category includes finance, insurance, real estate, communications, professional and personal services. The "other" industry category includes construction, transportation, and electric and other utilities.
[9] Revenue impacts of state tax bills are generally estimated for the years included in the normal state budget process, two to four fiscal years in most states.

law changes result in changes in the level or distribution of economic activity that can change tax bases compared to current law.

The revenue estimates of the impact of H.R. 1956 presented in this study do include specific short-to-intermediate run anticipated behavioral responses to the law change. For example, it is anticipated that there may be some businesses that might, in response to the bill, substitute independent contractors or agents for their own employees and eliminate nexus in a state. This change would only be made if it is consistent with a firm's business operating conditions, practices and objectives. Estimates of this type of behavioral response for businesses that have no establishment in a state are incorporated into the estimated loss percentages for each provision of H.R. 1956. As discussed in more detail in Appendix A, any tax loss resulting from this type of behavioral change would be partly offset by increased levels of economic activity and business taxes for in-state firms, such as contractors and affiliates. These offsetting tax increases have been considered in the estimates presented in Table 1.

Over a longer period of time, it is possible that existing businesses operating in a state may consider restructuring their current activities to reduce state and local taxes in response to H.R. 1956 if the economic costs of restructuring are less than the potential tax savings. However, H.R. 1956 explicitly preserves the authority of states to use tools currently available to state tax administrators to reduce the tax loss from restructuring attributable to sham transactions that lack economic substance or business purpose. H.R. 1956 also would not restrict the ability of legislators to make statutory changes to reporting requirements and apportionment provisions. Given the uncertainty of predicting longer-run behavioral responses to H.R. 1956, net losses related to this type of further restructuring have not been included in the revenue estimates.[10]

[10] The uncertainty of projecting behavioral responses was clearly pointed out in the California Franchise Tax Board's preliminary analysis of the revenue impact of H.R. 3220, an earlier version of the bill introduced in 2003. Its memorandum on the bill's tax impacts noted: "It is not possible to measure the impact of this federal bill for existing business practices in the state let alone for opportunities presented to restructure operations in order to reduce or eliminate business nexus in California." (California Franchise Tax Board, "Federal Business Activity Tax Proposal HR 3220, December 11, 2003, p. 1). While we believe that the methodology used in this study does provide reasonable estimates of H.R. 1956's tax impacts for current levels of economic activities, we agree that estimates of possible long-run restructuring impacts are too speculative to include in the analysis.

Comparing Estimates of H.R. 1956's Tax Impacts

Estimating the expected impact of this complex bill on state and local business tax revenues presents revenue estimators with a formidable challenge. They must first determine which specific state and local taxes are affected by the bill and then identify which taxpayers in specific industries will no longer have nexus in a state. The final step is to estimate the change in tax payments for current taxpayers that no longer will be taxable in a state.

The biggest challenge for state revenue estimators is the fact that tax return information for current taxpayers does not provide sufficient information to identify these impacts with any degree of certainty. For example, while estimators may be able to identify taxpayers with no reported payroll and property in a state, there is no information on the return to identify what percentage of firms with "small" factors may no longer have nexus under the bill's *de minimis* thresholds for physical presence. In addition, in many states only a limited amount of information is actually "captured" in processing returns and available for analysis. Finally, there is no information available from tax returns that can be used to predict short- or long-run restructuring opportunities for taxpayers.

Given these data limitations, both private- and public-sector revenue estimators must make key assumptions in estimating expected revenue impacts. It is understandable that different assumptions and estimating methodologies will result in an unusually wide range of revenue estimates for the bill. The range reflects both the limited amount of information available to estimators and important differences in assumptions about the taxes affected and how taxpayers will respond to the bill.

The very large variation in estimates of the impact of H.R. 1956 reported by CBO, NGA and E&Y is summarized in the table below.*

Report	Short-Run Impact	Long-Run Impact
Congressional Budget Office (CBO)	$1 billion	$3 billion
National Governors Association (NGA)	$2.2 to $3.1 billion	$4.7 to $8 billion
Ernst & Young (E&Y)	$434 million	not estimated

The following points may help to understand why there is such a wide range of estimates across and within the studies:

- It is clear from the state survey responses used to do the NGA estimates that the states did not agree on their interpretations of the bill's provisions. For example, some states included excise taxes and certain gross receipts taxes that are not affected by H.R. 1956. This is due partly to the fact that the NGA estimates were based on early versions of the bill. The CBO and E&Y studies reflect the latest, amended version of H.R. 1956 that clarifies which taxes and activities are affected.

- The individual state estimates used in the NGA study differ significantly in their estimating methodologies and assumptions. For the states using tax model runs, there is

wide variation in the minimum thresholds for payroll and property factors used to eliminate taxpayers assumed to have no physical presence. As a result of these differences, the short-run ("static") NGA tax losses, expressed as a percentage of business activity taxes, ranged from 0.0% to almost 40% for the 29 reporting states. The CBO and E&Y estimates applied more uniform assumptions and estimating methodologies across the states.

- The impacts of the bill are very sensitive to the composition of industries in a state. However, only a few states in the NGA study estimated the tax impacts industry-by-industry. The E&Y estimates were done on an industry-by-industry, provision-by-provision basis for the 12 selected states.

- The NGA and CBO analyses overstate the *net* short-run revenue loss from H.R. 1956 by not including increased instate activities and income for instate firms, such as independent contractors, that perform functions for firms that would no longer have nexus in a state. In addition, it appears that the NGA estimating methodology did not account for the fact that the majority of separate-filing states have now adopted add-backs of expenses related to the use of intangibles, such as interest and royalty payments paid to out-of-state affiliates. These add-back provisions will reduce any revenue loss from the bill's extension of P.L. 86-272 protections to intangibles.

- A comparison of the short-run and long-run impact figures in the table shows how significant the restructuring assumptions are in the revenue estimates. For CBO, roughly 67 percent of the long-run tax impact is due to restructuring; the comparable figure for NGA is as high as 73 percent. Because there is no information on current tax returns to predict these behavioral changes, these long-run estimates are more speculative than the revenue estimates normally used in the state legislative process.

[*] *Sources*: Congressional Budget Office (CBO) Cost Estimate, "H.R. 1956: Business Activity Tax Simplification Act of 2005" (July 11, 2006); National Governors Association (NGA), "Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States," (September 26, 2005); Ernst & Young (Estimates from Table 1.
Notes: 1) The short-run impacts for NGA are the minimum and maximum estimates of the "static" impact; the long-run impacts are the minimum and maximums sums for the static, dynamic and compliance impacts. 2) The CBO short-run impact is the reported first-year impact and the long-run impact is the reported fifth-year impact. 3) CBO describes the estimates as "more than $1 billion" and "about $3 billion."

Appendix A
Provisions of H.R. 1956

The following section provides an overview of the provisions of H.R. 1956 that may have a state and local tax revenue impact. In addition to describing the provisions, the discussion also provides additional details and examples of the expected revenue impacts of the provisions. The size of the revenue impact from these provisions would depend upon the economic structure of a state and specific tax system parameters, including tax rates, apportionment formulas, sourcing rules for sales and throwback provisions. As described in Appendix B, these factors were considered in deriving estimates of the revenue impacts of H.R. 1956.

I. Section 3: Jurisdictional Standard for State and Local Net Income Taxes and Other Business Taxes

3(a) Business must have a physical presence in a state to have jurisdiction to tax

This general provision establishes a physical presence nexus standard. In estimating the revenue impacts of H.R. 1956, the impact in this section is the loss in current revenue collections in selected states that assert nexus based on the concept of "economic" presence. In these states, businesses with no physical presence (in-state property or employees) may be currently subject to tax based solely on the presence of customers in the state. Revenue impacts for businesses that do have a physical presence in a state, including employees soliciting sales of services, are scored under the following sections of the bill.

3(b)(1) Employee Activities

H.R. 1956 establishes *de minimis* standards for certain in-state activities of employees that would not result in a physical presence in a state. The following employee activities are the source of potential revenue losses under the bill:

1. Employee activities in a state for less than 22 days

- States may lose taxes currently imposed on businesses because of in-state employees temporarily (fewer that 22 days) performing non-solicitation services. Examples that may create tax losses, assuming that the businesses are currently paying taxes when they have only such a temporary presence, include:
    - Engineers currently installing equipment or other employees servicing equipment in a state for less than 22 days.
    - Employees providing customer training in a state for less than 22 days.

2. Employees doing excepted activities (for any length of time), including:

- Activities relating to buying goods and services from instate businesses.
- Gathering news and covering events for media, such as reporters covering major sporting events.

- Meeting government officials for reasons other than selling goods and services. It is very unlikely that firms without an office or other physical presence in a state are currently subject to tax for this reason alone.
- Participating in educational or training sessions. This provision applies to employees merely attending sessions and does not apply to the firm presenting educational and training sessions. Any revenue loss related to this activity is expected to be minimal.
- Participating in charitable activities. These activities generally do not create nexus under current tax administration in most states, and, therefore, would not result in revenue losses.

3(b)(2) Non-Employee Activities

Nexus will not be established through the presence of non-employees (agents or contractors) in a state in the following situations:

1. Non-employee agents used to establish or maintain the market for more than 21 days if they work for *two* or more companies. (Non-employees working for one business for more than 21 days and providing activities to establish or maintain a market for more than 21 days will still establish nexus under H.R. 1956). This change may result in revenue reductions. Examples include:

   - Agents or contractors, including affiliates, accepting product returns or providing product pickups for the customers of out-of-state contracting firms.
   - Out-of-state power generators contracting with instate independent contractors to establish and maintain the market for selling electricity if the independent contractor provides such marketing services to at least two generators.

2. Non-employees providing other activities (i.e., non-market enhancing activities) as agents for a business will not establish nexus for the business, even if working for only one business. This will result in a revenue loss. Examples include:

   - Agents or contractors providing purchasing services to the out-of-state firm. These purchasing activities do not generally establish nexus under current law and administrative practices in most states. Therefore, any revenue loss from this activity is expected to be minimal.
   - Contractors, including subsidiaries, providing quality control manufacturing services or engineering support services for another business that does not have nexus in the state.

Any loss of revenue due to the fact that a contracting firm no longer has nexus because of the law change will be mitigated or partly offset by two factors. First, if the independent contractor and the contracting firm are members of a unitary group, the income of the two companies will still be combined in the states, such as California, that require combined unitary reporting for income tax purposes. While the change could result in the factors of the contracting firm that no longer has nexus being removed from the numerators of the apportionment formula in certain states, the combined income will not be reduced. Second, in the situation where a firm is no longer taxable in a state because of the transfer of work to an independent contractor, the

independent contractor's increased economic activity, income and, possibly, factors would increase and generate offsetting additional tax collections.

3(b)(3) Physical Presence of Real and Personal Property

Nexus is not be established through the presence of real and personal property in a state in the following situations:

1. Leasing or owning real and tangible personal property in a state for less than 22 days. This will result in a revenue loss in some situations if states currently have a *de minimis* period less than 22 days. Examples include:

    - Maintaining samples and display rooms in a state for more than a state's current *de minimis* period but less than 22 days.
    - A state currently asserts nexus for inventories held in the state for less than 22 days. This provision could affect businesses in retail and manufacturing (equipment needed to install machinery and equipment, for example), that have inventories in the state for less than 22 days (but more than any current *de minimis* period) during the year. It is likely, however, that a firm storing inventory in the state as part of their on-going business activities will hold inventory for 22 or more days a year. There would be a negligible revenue loss in this case.

2. Exemptions from nexus for certain tangible property held in the state for any length of time, including:

    - Tangible property located in a state for the purpose of being assembled, manufactured, processed or tested for another person would not establish nexus. This also applies to tangible property provided to an instate company, including an affiliate, that is used to provide services to an out-of-state company. Examples of possible tax losses from this provision include:
        - Elimination of nexus for an out-of-state business where the only physical instate presence is the out-of-state company's inventories stored instate for assembly or manufacturing by an instate contract manufacturer.
        - This provision could reduce taxes paid by companies that provide computer equipment, telecommunications switching equipment used for internet access, or research equipment to a third party providing instate services to the out-of-state company.

    - Marketing or promotional materials distributed in the state would not create nexus.

    - Any tangible property owned or leased by a firm that is ancillary to protected employee or agent activities would not establish nexus. Examples include:
        - Equipment used to cover news events.
        - Tangible property used by an independent contractor, including an affiliate, to provide services to the instate customers of an out-of-state company without physical presence in the state.

> The loss of revenue from this provision will be at least partly offset by higher taxes due to any increase in taxes paid by the instate affiliate or independent contractor through increased factors and income for a non-affiliate company or increased factors for an affiliate that is part of a unitary group (in states requiring combined unitary filing).

II. Removal of Certain Limitations on the Application of Public Law 86-272

Business taxes could be reduced through two provisions of H.R. 1956 that affect the application of P.L. 86-272.

1. Modification of P.L. 86-272 protections to solicitation of sales of services and intangibles (Sec. 2(a)).

This modification of P.L. 86-272 could reduce taxes for businesses that currently have nexus in a state based on solicitation activities related to the sale of services and intangibles (i.e., copyrights and trade marks). Any revenue loss from this provision would be mitigated, in many states, by income tax sourcing rules that source sales using the greater cost of performance of services or the location of actual costs of providing services. In these states, the sales factor, and taxable income, will be relatively small for firms that have nexus only because of solicitation activities. The loss could be more significant in states using market state sourcing rules for services, including financial services.

2. Application of P.L. 86-272 to other business activity taxes (Sec. 2(b)).

H.R. 1956 extends P.L. 86-272 protections to other business activity taxes, including direct taxes on gross receipts (excluding insurance premiums taxes), gross income or profits; business license and business occupation taxes; franchise taxes; Michigan's single business tax; and capital stock taxes. The term "other business activity taxes" does not apply to transaction taxes.

Appendix B
Study Methodology and Data Sources

The estimates of the revenue impact of H.R. 1956 start with an estimate of the fiscal year 2005 state and local tax collections by tax type that could be affected by the bill. These include corporate income and franchise taxes and other business activity taxes. In addition to including all states and the District of Columbia, the estimates include impacts for the states that have significant local taxes on business income, gross receipts or other business activity taxes. States with significant local business taxes include: Maryland, Michigan, Missouri, New York, Ohio, Oregon, Pennsylvania and Virginia.

The use of actual tax collections incorporates the level of compliance under current law and administration. In situations where taxpayers are litigating a state's nexus provisions and are not required to pay the contested liabilities, the actual collections do not include this disputed revenue. On the other hand, where taxpayers have paid taxes and are challenging the liability through refund actions, such amounts are included in actual collections. The revenue estimates reflect the level of state and local tax reductions that would have occurred in fiscal year 2005 if the provisions of H.R. 1956 applied to all tax years generating business tax collections during the fiscal year.

In addition to the data sources described in the following sections, individual state responses to a survey conducted by the Multistate Tax Commission, as part of the National Governors Association analysis of the impact of H.R. 1956, were also reviewed for this analysis. The survey responses provided additional information on the type and amounts of business activity taxes that could be affected by the bill, as well as possible revenue impacts for individual states.

The estimating steps are:

1. Estimate the *current state and local business taxes* that are covered by H.R. 1956 in each state.
2. Determine the sales, by industry, into a state by companies with no establishment in the state.
3. Estimate the effective state and local tax rate per dollar of sales and multiply by the sales for firms without an establishment to determine the *taxes paid by firms with no instate establishments*.
4. Determine the percentage reduction in these taxes that will occur due to the nexus changes related to each of the provisions in H.R. 1956.
5. Apply these percentages, by major industry group, to the taxes associated with sales into the state from companies with no establishment in the state to determine the *expected state and local tax losses* from H.R. 1956.
6. *Extrapolate* the results from the included states to all 50 states and the District of Columbia.

The following sections provide more detail on the methodology used to estimate the impact of the bill on corporate income tax collections, the primary source of the revenue loss, and other business activity taxes.

Current Taxes Paid by Multistate Business. The revenue impact of the bill will come primarily from multistate taxpayers that are paying corporate income and other business activity taxes affected by H.R. 1956. Fiscal year 2005 tax collections for the affected business taxes are from state forecasts and E&Y projections based on the latest available U.S. Census, *Governmental Finance* reports. In some cases, we also contacted state revenue agencies for additional details.

Sales into a State from Firms without Establishments in the State. To derive an estimate of the taxes reported by taxpayers with minimal physical presence in a state – taxpayers expected to be affected by H.R. 1956 -- we determine the sales coming into a state from companies that have no establishment in the state. These firms do not maintain an office, store, warehouse, or other facility in the state. The underlying information for these calculations is from the U.S. Bureau of the Census, *Enterprise Statistics* (1992). This information was combined with IRS Statistics of Income data to determine the share of U.S. sales made by firms without an establishment in a state.

The next step is to determine imports into the state, by industry, using data from state IMPLAN (Minnesota IMPLAN Group, Inc.) models for the twelve specific states. The import estimate is combined with the above share estimate, to estimate the percent of total import sales in each industry provided by firms with no instate establishments.

Effective Tax Rates per Dollar of Import Sales. The import sales figures from the prior step are multiplied by estimated effective tax rates per dollar of sales to determine the taxes paid by firms with no instate establishments. In determining the effective state and local tax rate on import sales, where available, actual state income tax data on sales and taxes for apportioning firms was used to determine taxes per dollar of sales. For other states, effective tax rates were determined by dividing taxes by sales for all taxpayers. The effective tax rates incorporate general tax system features, such as nominal tax rates and weights on apportionment formula factors.

Tax Losses. The final step is to determine, by industry, what percentage of the taxes paid by firms with no instate establishments are expected to be eliminated due to the nexus provisions of H.R. 1956. State-by-state information on current-law nexus provisions, as reported in Bureau of National Affairs, Inc., *Special Report: 2004 Survey of State Tax Departments* (April 23, 2004), were used to estimate these percentages. Based on this information, a review of each provision of H.R. 1956, and our experience in estimating state and local business taxes, state-by-state loss percentages, were assigned by bill provision to each of nine major industry groups. This step considers both the types of firms that will be affected and additional state tax features, such as income tax sourcing rules for sales and taxpayer filing options. For example, if a state requires combined reporting, the loss percentages for a specific industry are lower than the percentages assigned to firms in separate filing states. This reflects the fact that the combined income in a unitary state would not be reduced if an affiliated firm no longer has nexus due to H.R. 1956. The taxes associated with sales into a state by firms with no instate establishments were multiplied by the loss percentages for each provision to estimate the total state and local business tax losses expected from H.R. 1956.

Extrapolation to Other States. The estimated losses for the twelve included states were used to determine the tax losses in the remaining states. Ratios of estimated tax loss to total business activity taxes for the included states were applied to the total business activity tax estimates in the remaining states to estimate the losses in the non-included states. Different ratios were used for separate filing states and combined reporting states. In addition, the ratios were adjusted to recognize state-by-state differences in corporate income tax nexus and sourcing rules.

Responses to Questions for the Record from Michael Mundaca
Senate Finance Committee Hearing of July 25, 2006

From Senator Hatch:

At the international level the rule is that for an entity to be liable to pay taxes in another country it must have a permanent establishment in the country wishing to tax it. This standard has been arrived at by the OECD in a near unanimous consensus of its members. However, at the state level we have no permanent establishment requirement to require taxation. In fact, foreign countries that are exempt from taxation at the federal level can still be liable to pay taxes at the state level. Mr. Mundaca, does it make any sense for state entities (but not the federal government) to tax foreign companies doing business in the United States? Do foreign countries do this to U.S. businesses? Given that we have a consensus on the need to establish a permanent establishment before it makes sense to tax an entity in a locale at the international level, why would it not make sense to apply that same standard at the national level as well amongst the states?

Response:
You are correct, Senator, regarding the role of the permanent establishment, or "PE," standard in international taxation. The PE standard is found in every one of the more than 60 U.S. income tax treaties, as well as in most of the literally thousands of bilateral tax treaties in force between countries around the globe. The PE concept originated in the work of the League of Nations, in the 1920s, spurred in part by efforts of some governments to levy income tax on foreign corporations that simply had customers in their country. Concerned with this expanding jurisdiction over business income, the League of Nations recommended that countries agree bilaterally to impose income tax on the business income of a foreign corporation only if the foreign corporation had a substantial physical presence in their country. Both the OECD model tax treaty and the United Nations model tax treaty adopt the PE standard. In addition, the standard has been incorporated into the internal law of many jurisdictions.

The U.S. PE rules included in our tax treaties do not apply to limit the application of U.S. state and local income taxes, and therefore, as you note, a foreign corporation may be exempt from income taxation on the federal level (because it has no physical presence in the United States), but may nevertheless be subject to state and local income taxation. This has occurred in the past to foreign corporations with business activities in the United States and continues to happen today. Conversely, no foreign countries that I am aware of currently impose income taxes on a local level on U.S. corporations that do not have a permanent establishment within their country.

The international consensus regarding use of the PE concept has created needed uniformity, predictability, and certainty for multinational corporations and other

taxpayers. It has helped to mitigate double taxation and prevent tax jurisdictional disputes. In addition, it has alleviated the administrative burden that would be imposed on multinationals if they were forced to file net basis income tax returns in every jurisdiction in which they have customers or other sources of business income.

From Senator Wyden:

Advocates for H.R. 1956/S. 2721 say the measure will simplify the determination whether business has enough connection to a state to be obligated to pay tax. Wouldn't the factor presence nexus proposal discussed in Mr. Bucks' testimony provide simplicity with more consistency than these bills would provide?

Response:
To the extent that the standard proposed in H.R. 1956/S. 2721 is based on the permanent establishment standard employed internationally, the standard has the advantage of having been in place and used by governments and taxpayers for over 80 years. It is thus familiar to both taxpayers and tax administrators, and would result in state and local taxation on a basis consistent with international taxation, thus mitigating double taxation and potential jurisdictional disputes. In addition, the use of a single standard internationally and domestically would result in administrative simplicity and consistency for taxpayers.

From Senator Schumer:

In the Supreme Court decision in the Quill case, the Court decided that a physical presence standard makes sense in the case of the imposition of sales and use taxes. Can you explain why a different standard should be applied in the case of business activity taxes?

Response:
It could be argued that in the case of income taxes, the issue is when a tax obligation should be imposed, in contrast to the issue in the case of sales and use taxes, which is when a tax *collection* obligation should be imposed. It could be further argued that even in the international context, such a distinction is recognized, in that value-added tax collection obligations are imposed in certain cases on taxpayers that do not have a permanent establishment in the jurisdiction and thus could not be subject to income taxation. Nevertheless, there does not appear to be a compelling reason for making such a distinction. In fact, it could be argued that the imposition of an income tax should be subject to a *higher* threshold than the imposition of a sales and use tax collection obligation, because in the former case, a substantive tax liability is being imposed (which therefore actually reduces the income the foreign taxpayer) while in the latter case a mere administrative burden is being imposed (which although not without cost, does not otherwise reduce the income of the foreign taxpayer).

The State *of Wyoming*

DEPARTMENT OF REVENUE

Herschler Building
2nd Floor West
122 West 25th Street
Cheyenne, Wyoming 82002-0110
E-Mail: dor@wy.gov
Web: http://revenue@state.wy.us

DAVE FREUDENTHAL, *Governor*
EDMUND J. SCHMIDT, *Director*

Telephone (307) 777-7961
DOR Main FAX (307) 777-7722
Ad Valorem FAX (307) 777-7722
Excise FAX (307) 777-3632
Mineral FAX (307) 777-7849
Liquor FAX (307) 777-6255

July 25, 2006

Subcommittee on International Trade
Senate Committee on Finance
Attn: Senator Charles E. Grassley, Chairman
Washington DC 20510-6200

RE: Testimony of Daniel W. Noble, Administrator, Excise Tax Division, Department of Revenue before the Subcommittee on International Trade, Senate Committee on Finance

Mr. Chairman and Members of the Subcommittee on International Trade,

I am honored to present this testimony to the Subcommittee on International Trade on behalf of The Great State of Wyoming and the Wyoming Department of Revenue. As a small rural state, Wyoming will be greatly impacted by the work of this committee and the work of Congress related to the issue of taxation of remote sales.

Over the last six and one half years a group of forty-two states and the District of Columbia have formed an alliance known as the Streamlined Sales Tax Project (SSTP). This alliance of states and the District of Columbia has worked together with representatives of the business community to develop a more uniform and simplified sales and use tax system. The goal of this project has been to create a tax environment for business which removes many of the burdens that have been placed on businesses

by state and local sales and use tax laws. The SSTP also hopes to level the playing field between traditional "brick and mortar" retailers and remote retailers. This has proven to be a monumental task but there has been significant progress made.

Probably the single most difficult challenge faced by this group has been the balance that had to be struck between state and local governments need to maintain taxing authority at the various levels of government and the need to remove the burden for collecting those taxes from businesses. To achieve this balance the state and local governments have agreed to assume this burden both in creation of a simpler tax code and by providing a mechanism for businesses to collect sales tax on their sales. In order to remove this burden from businesses the states crafted an agreement which radically simplifies tax laws in the member states, develops more efficient administrative procedures and exploits emerging technologies to manage the many taxing jurisdictions in this country.

The agreement currently in effect addresses the following areas of concern raised by businesses during our deliberations:

- **State funding of the technology used to collect the tax.**
- **Centralized registration for sellers**
- **Rate simplification**
- **State level tax administration of all state and local sales and use taxes**
- **Uniform sourcing rules**

- **Simplified exemption administration for use and entity-based exemptions**
- **Uniform audit procedures**

Utilizing technology to accurately collect the tax

The states have partnered with two technology vendors to provide a tax calculation engine for businesses which choose to utilize their services. These vendors are compensated from the tax revenue generated from their clients. The states went through an exhaustive certification process to test these vendors accuracy at returning the appropriate tax rate as well as the identification of exempt products from test information supplied by the states.

The states received the very first electronic transmission of a tax return from one of the technology providers on July 20th of this year. Contrary to any testimony you may have received previously the technology and software does exist to accurately calculate taxes due and provide that information to vendors. This process is very similar to the technology used to authorize credit card transactions. Credit card transactions have become a standard for authorization of payments in electronic commerce.

There are also vendors coming forward to have their software certified by the states so that they can market the software directly to clients that wish to perform the tax calculation process in-house. One vendor's software has already been certified and will be available shortly.

The states have developed a centralized registration system which has been operational since October of 2005. There have been over seven hundred voluntary registrants utilizing the system since its inception. The state of Wyoming has collected from these vendors approximately $237,000 in sales and use taxes since October of last year. Previously several vendors voluntarily licensed with the SSTP and began remitting tax to all the governing states. Wyoming has received well over one million dollars in revenue from these vendors.

Simplified rates

It is true that the Streamlined Project was unable to achieve a consensus on adoption of the single rate per state concept and the removal of local jurisdictions ability to impose separate taxes. There was extensive debate regarding the single rate concept early in the development of the agreement.

It is important to understand the reason states needed to retain the integrity of the various rates charged by state and local governments. Local governments separately budget their revenue streams from state revenues. In many instances local governments utilize their tax revenues to collateralize bond issues and other borrowing instruments. This facilitates construction of infrastructure needs within these jurisdictions. To remove the ability of local governments to assess these taxes could limit these types of funding mechanisms.

More importantly limiting states to a single tax rate removes the autonomy of local governments and their citizens to tax themselves. The states recognize the complexity created by maintaining these rates. We are willing to assume the financial and administrative burden to manage this complexity. From the actions of the governing states I believe it is safe to say that we have demonstrated this willingness to assume this role.

There have been some rate simplifications achieved by the project. All states must have a common tax base between local tax and the state tax. In other words something which is taxable for the state tax must also be taxable locally. The one exception to this is food. Also rates which once could potentially change virtually any day of the year are now only allowed to be changed at the beginning of a calendar quarter and only after 60 days notice (or 120 days notice for catalog vendors).

Previously Congress has been told that the single rate per state would resolve merchant compliance problems in this country. If that is truly the case then why are remote vendors not collecting in the states with a single tax rate? The state of Wyoming has had a single tax rate in place for all vendors that have no physical presence in Wyoming since 1991. This date roughly coincides with the U.S. Supreme Court's decision in Quill v. North Dakota. The states of Rhode Island and Michigan have a single tax rate in their states. If the states are willing to remove this burden on these merchants by utilizing technology to do so then is not the same objective achieved?

State level administration of the tax

One of the major simplifications required under the Streamlined Sales and Use Tax Agreement has been the requirement for state level administration of the tax. If all states eventually adopt this provision of the agreement companies that sell into all states will drastically reduce their filing and remittance requirements as well as a major reduction in their exposure to audits. This is a simplification measure which will aid all vendors.

Uniform Sourcing Rules

The adoption of uniform sourcing rules for the states has been achieved under the agreement. They are very detailed and clearly identify where tax is due. Destination sourcing was chosen as it most closely credits the tax to where the taxpayer is located. One of the fears of the Project was that if origin sourcing were adopted safe harbors would be created in states that impose no sales tax. This stance on destination sourcing has not come without difficulty within the states. Some states are not currently adopting conforming legislation because they will experience a revenue shift by converting to destination sourcing. While there have been several challenges by states to destination sourcing the Governing Board has continued to support destination sourcing.

The sourcing rules in place also address industries which have had difficulty in the past adapting to the various rules of individual states. The telecommunications industry and leasing industries have been very active in moving these rules forward.

Simplified Exemption Administration

The business community presented to the Project early in our deliberations concerns about the various exemption requirements of the states. Each state used a different form, had different renewal requirements and viewed the relief from liability provided by an exemption certificate differently. Some states required pre-numbered certificates and would not allow blank certificates. From the Streamlined Sales Tax Project has evolved a common exemption form, a removal of renewal requirements and a relaxation of the good faith requirement to minimize vendor liability.

Uniform Audit Procedures

Audit procedures are currently under development for all vendors that choose to utilize one of the technology models. One of the more attractive features related to use of the Streamlined Technology is that the seller will not be subjected to audit on their sales. This effectively limits the scope of their audits to their purchases. State level administration will also limit audits of many vendors.

An issue which must be addressed by the states that impose a sales and use tax is the evolution of commerce from the tangible world to the electronic world. Items which several years ago were only available in a form that was easily identifiable as tangible personal property are now sold in electronic form. Books, movies, newspapers, magazines and music are now sold electronically in a downloadable format. New

service industries are developing with the evolution of commerce. Businesses are creating new ways to market products and services.

The member states of the Streamlined Sales and Use Tax Agreement are working diligently with industry to address the administration and imposition of sales tax on these new products and services. As these new products and services migrate from the tangible world to the electronic world the tax that would be charged will erode as part of this evolution. The states must modernize their tax laws to prevent this erosion of revenues.

Conclusion

The amount of revenue at risk for the states is something that has been debated extensively. Depending on the study you read the numbers can be fairly small to enormous. The fact is, there are significant revenues which remain uncollected each and every day in this country because of the increase in remote sales transactions brought about by our entry into the electronic age and the fact that these remote sellers are not collecting the tax. Virtually every audit assessment I sign has purchases which have gone untaxed. Arguing over the magnitude of the problem is not productive. Every one of us knows intuitively that this is a significant problem.

The only efficient method for the collection of sales and use tax revenues is to require taxation at the point of sale. Until states can require vendors to collect these taxes this erosion of revenues will continue.

Wyoming believes that the states have demonstrated to Congress a willingness to minimize the burdens placed on businesses when collecting our sales taxes. What is missing is direction. We need to know if we have removed enough of the burdens from vendors for Congress to require collection of tax from all vendors. If we have not achieved that threshold then tell us what else is required. We need specific guidance on what it will take to capture the revenue that is currently not being collected. The Governor of the State of Wyoming, Dave Freudenthal, supports the concept of the project but believes that the only way for states to decisively act on simplification is to receive direction on what is expected of them through federal legislation. Establish a threshold for the states that will allow us to work productively towards a modern and simplified tax system which will not burden vendors and will efficiently capture this revenue.

Again I would like to thank you for the opportunity to provide testimony on an issue which has developed momentum over the years but desperately needs your help.

The State *of Wyoming*

DEPARTMENT OF REVENUE

Herschler Building
2nd Floor West
122 West 25th Street
Cheyenne, Wyoming 82002-0110
E-Mail: dor@wy.gov
Web: http://revenue@state.wy.us

DAVE FREUDENTHAL, *Governor*
EDMUND J. SCHMIDT, *Director*

Telephone (307) 777-7961
DOR Main FAX (307) 777-7722
Ad Valorem FAX (307) 777-7722
Excise FAX (307) 777-3632
Mineral FAX (307) 777-7849
Liquor FAX (307) 777-6255

Responses to Questions for the Record from Daniel W. Noble
Finance Committee Hearing of July 25, 2006

From Senator Hatch:

"Mr. Noble, many state administrators have mentioned that efforts on the part of states to collect use taxes on merchandise purchased by a state's citizens in other jurisdictions are just plain ineffective. Are there any innovative ideas being discussed that might increase taxpayer compliance with use tax requirements?"

Response:

Senator Hatch, during the years of deliberations that I've attended as a participant of the Streamlined Sales Tax Project there have been many ideas presented by both governmental entities and representatives of the business community. Some of the presentations offered by businesses included required self reporting by individual taxpayers. Annual declarations of use tax due from consumers and businesses through the use of income tax returns or individual inquiries have been implemented in some states. The results of these attempts have produced negligible results.

One option offered by the states would be similar in approach to the Jenkins Act. It would require vendors to report their remote sales to the states so that the states could bill the consumer for the tax directly. This is extremely inefficient when you consider the number of remote transactions that occur each day in this country. To bill for a use tax transaction which may have generated one dollar in tax is not worth the labor it would take to collect it.

The only efficient way to collect sales and use tax is to collect it at the moment of the sales transaction. As the price is negotiated the tax is added as part of the exchange. This is convenient for the purchaser since the tax on the transaction may only be a few cents. To ask the consumer to keep track of each transaction they make during a year is not feasible. The seller is already collecting information on the sale for their own accounting purposes so the collection of the tax is merely an extension of the sale.

What makes the collection of these taxes burdensome for businesses is determining if tax is due on the transaction and if so, at what rate. Also problematic for businesses are all the various administrative requirements placed on these companies by the states. This very issue is what brought the U.S. Supreme Court to its decision in Quill v. North Dakota. The approaches which the states are using to remove the burdens mentioned above are simple in some aspects and quite innovative in other aspects.

Minimizing the administrative burdens on businesses by creating a uniform method for reporting the tax and minimizing the number of reports and remittances is a simple

approach to lessening the burden on businesses. The Streamlined Sales and Use Tax Agreement achieved major simplifications in this area. Additionally the agreement is being updated constantly as new definitions are added. These definitions must be adopted by all member states. Member states are only allowed to change local tax rates four times annually and must provide adequate notice to sellers. Audit procedures are being developed which will simplify the process and minimize the number of audits faced by businesses.

The above solutions are the simple approaches to minimizing these burdens. The most innovative approach to gaining compliance from taxpayers on use tax purchases is through the use of technology. The states recognized early in the project meetings that removal of the authority for local governments to impose tax on their citizens was not feasible. The only logical approach for maintaining this level of complexity of rates and tax boundaries and removing the burden on sellers was for the states to assume that burden. We, the states, have effectively accomplished that goal through our partnership with software companies to develop a technological model that produces accurate tax calculations for sellers and reports this tax to the appropriate taxing jurisdiction.

These tax calculation software programs have existed for years. What is new to this process is that the member states are supplying the rates and boundary databases to the service providers as well as taxability matrices. The provision of these items to the service providers removes a huge amount of liability and expense from these providers and forces the states to put taxability of products in simple terms.

The benefits to sellers both brick and mortar as well as remote sellers is phenomenal. The appropriate tax rate is identified by the service provider electronically at the moment of the sale in the same way as a credit card transaction is authorized. As the seller is processing the credit card information the tax rate is being identified from the address information provided by the purchaser.

While the technology to make this process a reality has existed for years, this implementation of a common process is unique and innovative in its approach. The states are willing to bear the cost of this technology and also willing to prove to the Congress that we can work together to simplify and modernize sales and use tax in America. Just getting forty-two states together and having them work with the business community to reach consensus on numerous tax policy issues is incredible.

From Senator Bunning:

"Some might think that it is somewhat unusual that state tax policy would be discussed in the International Trade Subcommittee, but in our increasingly global economy, tax and regulatory policies at the state and local level can actually have an impact on job creation and economic growth. There have been small business compliance and cost concerns raised in connection with the SSTP. One of these concerns is that this new tax collection, remittance and record keeping burden would be borne by U.S.–based small businesses that are remote sellers, but not by overseas remote sellers. In other words, the SSTP obligations could be enforced for US-based businesses but not

foreign-based businesses, creating a new slanted playing field undermining US-based remote sellers. Your comments on these concerns?"

Response:

Senator Bunning, I believe that you describe the very dilemma that exists today for brick and mortar stores in this country. Brick and mortar stores are currently facing a slanted playing field when they are required to collect sales tax and remote vendors (including international vendors) are not required to. This effectively undermines their ability to compete with both US and International remote vendors. Putting US remote vendors on equal footing with brick and mortar vendors in this country solves one inequity. Only the inequity existing between all US-based businesses and international businesses would remain.

Fair International commerce in today's global economy is something which I believe can only be administered by the federal government through trade agreements with our international partners. I do not believe that our US based remote vendors can be forced to collect another countries use or VAT tax anymore than international vendors can be forced to collect our taxes. As long as we have equal access to their markets we are on an equal playing field with international remote vendors.

Should we not have equal access to their markets then I believe it is the role of Congress to eliminate those inequities.

One dilemma which both the states and the federal government must begin to address is the emergence of electronic commerce in our world today. There are electronic products which have displaced their tangible counterparts in the new economy. We must develop tax policy to address the taxability of these new commodities. These sales can originate from any location in the world and be sold to any location in the world. International trade will become invisible to state and local government as well as the federal government. There is currently no electronic counterpart to U.S. Customs.

We must work together to address this issue. I believe that the challenges we face with international trade should in no way affect moving forward and leveling the playing field within our own borders.

SUBCOMMITTEE ON INTERNATIONAL TRADE
COMMITTEE ON FINANCE
UNITED STATES SENATE

JULY 25, 2006

TESTIMONY OF SPEAKER CHRISTOPHER RANTS
IOWA HOUSE OF REPRESENTATIVES
CO-CHAIR, EXECUTIVE COMMITTEE TASK FORCE ON STATE & LOCAL TAXATION OF TELECOMMUNICATIONS AND ELECTRONIC COMMERCE
NATIONAL CONFERENCE OF STATE LEGISLATURES

Chairman Thomas, Ranking Member Bingaman and members of the Subcommittee on International Trade, I appreciate the invitation to testify before you today on behalf of the National Conference of State Legislatures (NCSL). I am Christopher Rants, Speaker of the Iowa House of Representatives and I serve as Co-Chair of the National Conference of State Legislatures' Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce. The National Conference of State Legislatures is the bi-partisan national organization representing every state legislator from all fifty states and our nation's commonwealths, territories, possessions and the District of Columbia.

I am pleased to have the opportunity to speak to you about state and local taxation in the new economy, specifically, the ability of state and local governments to collect the sales and use tax presently owed on transactions with remote sellers, which occur primarily through electronic commerce. Let me make this very clear, state legislators are not advocating any new or discriminatory taxes on electronic commerce. We desire, however, to establish a streamlined sales and use tax collection system that is seamless for sellers in the new economy and respects the sovereignty of state borders.

The new economy or if you prefer, electronic commerce, which is not bound by state and local borders makes it critical to simplify and reform state and local taxes to ensure a level playing field for all sellers, to enhance economic development, and to avoid discrimination based upon how a sale may be transacted. Government can not allow a

tax system that was designed for an economy that existed almost 80 years ago, to be the deciding factor as to where our constituents make a transaction.

Sales Tax Popularity

As we all know, taxes are never popular. However, if state and local governments are to provide necessary services, such as education and public safety, then we need to maintain our ability to levy taxes. In surveys of taxpayers as to which tax of all the major federal, state and local taxes they dislike the least, the surprising answer has consistently been the sales tax.

Voters all over the country have approved local sales taxes to pay for sports stadiums, added police protection, land acquisition for open space, and transportation improvements. The taxpayers of the state of Michigan overwhelmingly voted to use the sales tax as opposed to property tax as the major source of revenue for education and then in following years, they have voted to increase the sales tax in order to provide additional funding for education.

The general sales and use tax is the primary consumption tax for state and local governments. In 2005, sales taxes accounted for one-third of state revenues – over $ 311 billion – with the largest percentage of the funds used to finance K-12 education.

Sales Tax and Electronic Commerce

The problem states have with the sales tax is that the tax base keeps shrinking. In the 1930s, when the sales tax was first imposed, consumers bought goods from the local merchant and it was not that difficult for the merchant to collect a few cents on the dollar.

Also, most Americans spent very little on services – they spent most of their money on taxable goods. And there were very few "remote sellers."

In the 1970s and 1980s, the share of personal consumption expenditures began to shift from taxable goods to services – things like medical care, health clubs, legal and accounting services. So the sales tax was applied on a smaller and smaller share of tangible products. This was compounded on the goods side by mail order outlets selling goods without collecting sales taxes from their customers – a practice sanctioned by the U.S. Supreme Court in the *National Bellas Hess* case in 1967 and reaffirmed in the *Quill* decision in 1992.

Today, states face a new threat to sales tax revenue, electronic commerce, with the potential to dramatically expand the volume of goods sold to customers without collection of a sales or use tax. The combined weight of the shift to a service based-economy and the erosion of sales tax revenues due to electronic commerce threatens the future viability of the sales tax and essential governmental services such as education and public safety.

According to the Center for Business and Economic Research at the University of Tennessee, in 2003, the estimated combined state and local revenue loss due to remote sales was between $15.5 billion and $16.1 billion. For electronic commerce sales alone, the estimated revenue loss was between $8.2 billion and $8.5 billion. The report from the University of Tennessee further estimates that the revenue loss will grow and that by 2008, the revenue loss for state and local governments could be as high as $33.6 billion, of which it is estimated that $17.8 billion would be from sales over the Internet. (See Table 1)

Table 1

Combined State & Local Revenue Losses from E-Commerce and All Remote Commerce – 2008

Source: Dr. Donald Bruce & Dr. William Fox, Center for Business & Economic Research University of Tennessee

State	E-Commerce Loss (millions)	All Remote Sales (millions)
Alabama	238.7	449.7
Arkansas	190.6	359.2
Arizona	435.7	821.1
California	2452.0	4620.4
Colorado	287.8	542.4
Connecticut	266.0	501.2
District of Columbia	48.8	91.9
Florida	1248.2	2351.1
Georgia	600.0	1130.5
Hawaii	130.3	245.5
Iowa	**141.4**	**266.4**
Idaho	**66.3**	**125.0**
Illinois	582.2	1097.0
Indiana	323.6	609.7
Kansas	178.8	336.9
Kentucky	**214.6**	**404.3**
Louisiana	409.8	772.2
Massachusetts	286.4	539.6
Maryland	265.9	501.1
Maine	**67.2**	**126.6**
Michigan	587.3	1106.6
Minnesota	381.2	718.3
Missouri	313.9	591.5
Mississippi	**191.9**	**361.6**
North Carolina	405.9	764.9
North Dakota	**34.3**	**64.6**
Nebraska	123.4	232.4
New Jersey	469.9	885.5
New Mexico	**140.4**	**264.6**
Nevada	186.6	351.5
New York	**1288.4**	**2427.7**
Ohio	608.6	1146.8
Oklahoma	185.4	349.3
Pennsylvania	585.6	1103.4
Rhode Island	58.5	110.3
South Carolina	209.4	394.5
South Dakota	47.0	88.6
Tennessee	**508.3**	**957.9**
Texas	1634.5	3079.9
Utah	**150.7**	**284.0**
Virginia	294.8	555.4

National Conference of State Legislatures

Vermont	29.1	54.8
Washington	574.6	1082.7
Wisconsin	303.4	571.7
West Virginia	**86.6**	**163.2**
Wyoming	**38.9**	**73.3**
US	**17,872.9**	**33,677.8**

As state legislators, we recognize that we have been part of this problem. Over the last 80 years, state and local policymakers have created a confusing, administratively burdensome tax system with very little regard for the compliance burden placed on multi-state businesses. In 1999, NCSL passed a resolution, written by NCSL's Task Force on State and Local Taxation of Telecommunications and Electronic Commerce, that acknowledged that states need to simplify their sales and use taxes and telecommunications taxes for the 21st Century. We recognize that we have been a key part of the problem and we accepted the fact that it was our problem to solve.

In our resolution, we formulated a set of seven principles that we used to develop a proposal for simplifying and streamlining state and local sales and use tax collection systems. The overriding theme of those seven principles is competitive neutrality. State legislators from across the country unanimously approved this resolution that declared, "state and local tax systems should treat transactions involving goods and services, including telecommunications and electronic commerce, in a competitively neutral manner." The resolution further stipulated, "that a simplified sales and use tax system that treats all transactions in a competitively neutral manner will strengthen and preserve the sales and use tax as vital state and local revenue sources and preserve state fiscal sovereignty."

The Cost of Collection for Sellers

As you are aware, the sales tax is imposed on the customer, not the seller. Sellers determine the sales tax to be collected, collect the tax and remit the tax collected to the state (in four states, Alabama, Arizona, Colorado and Louisiana, sellers also must remit the local portion of the sales tax directly to the local government). Under the current sales tax system, the seller also is liable for any mistakes that might occur due to misinformation from the buyer or even the state. This means that the seller is liable for any uncollected sales tax plus interest and penalties.

A recent national survey commissioned by the Joint Cost of Collection Study, a public / private sector group, and conducted by PricewaterhouseCoopers LLP, has shown that in fiscal year 2003 the total cost to sellers to collect state and local sales taxes was $6.8 billion. This amount was calculated after subtractions for state vendor discounts and retailer float on the sales tax revenues.

The study showed that for fiscal year 2003, retailers selling between $150,000 and $1 million the average cost was 13.47 percent of the sales taxes collected or approximately $2,386; for mid-size retailer, between $1 million and $10 million in sales, the average cost was 5.2 percent or approximately $5,279; and for the larger retailers, over $10 million in sales, the average cost of collection was 2.17 percent or approximately $18,233. It is important to remember that these amounts, including the total cost for all retailers of $6.8 billion, are not reimbursed to the retailer by the state or local government, these costs comes out of the retailer's own pocket.

The burden on retailers to comply with forty-six different sales tax systems and the monetary cost to retailers for compliance resulted in the two Supreme Court decisions, cited above, that prohibited a state from requiring an out-of-state seller from collecting sales tax on a purchase made by a resident of the state.

Solution: Streamlined Sales and Use Tax Agreement

Beginning in 2000, state legislators, governors and tax administrators, along with representatives of retailers and others in the private sector, started the process to develop a simpler, uniform and fairer system of sales and use taxation, that removes the burden imposed on retailers, preserves state sovereignty, levels the playing field for all retailers, and enhances the ability of U.S. companies to compete in the global economy. The urgency to develop such a system, caused NCSL's Executive Committee to set aside NCSL's rule of non-interference in state legislation, to endorse model legislation committing sales tax states to multistate discussions on developing a fairer and simplifier system. By 2002, 35 states had enacted this legislation, sending delegations composed of legislators, tax administrators, local government officials and representatives of the private sector to monthly meetings that resulted in the formulation and approval of the Streamlined Sales and Use Tax Agreement. As of today, all of the sales tax states, except for Colorado, are participating in the ongoing process to simplify sales tax collections.

The key features of the Agreement are SIMPLIFICATION of sales and use tax laws and administration; the USE OF TECHNOLOGY for calculating, collecting, reporting and/or remitting the tax; and, STATE ASSUMPTION OF THE COSTS of collection for remote sellers. The key simplifications contained in the Agreement as adopted by the states are:

- Uniform product definitions, including for food and related items
- Uniform state and local tax base
- Reductions in the number of tax rates
- Requirements for state/central administration
- Central seller registration
- Uniform returns and remittances
- Simplified exemption administration

- ➢ Uniform audit procedures / reduction of the number of audits
- ➢ Uniform privacy protections
- ➢ Notice requirements for rate changes
- ➢ Uniform sourcing
- ➢ Uniform telecommunications sourcing
- ➢ Uniform administrative definitions
- ➢ Eliminations of caps and thresholds on rates
- ➢ Standardization for sales tax holidays
- ➢ Uniform rounding rule

Since the Agreement was ratified in November 2002, 21 states have enacted legislation to bring their sales tax statutes and administrative rulings into compliance with the Agreement. On October 1, 2005, thirteen states with a population of over 55 million residents, including my own state of Iowa, were certified to be fully in compliance with the Agreement. An additional six states will be in full compliance by January 1, 2008. Two additional states enacted compliance legislation during this year's legislative session.

Table 2.
Member States on 10/01/05

Indiana,	**New Jersey**
Iowa	**North Carolina**
Kansas	**North Dakota**
Kentucky	**Oklahoma**
Michigan	**South Dakota**
Minnesota	**West Virginia**
Nebraska	
Associate Member States – Full Compliance as of 01/01/08	
Arkansas	**Tennessee**
Nevada	**Utah**
Ohio	**Wyoming**
States Enacted Compliance Legislation in 2006 – Not Yet Certified	
Rhode Island	**Vermont**

Sales Tax Fairness and Simplification Act

The Streamlined Sales and Use Tax Agreement is voluntary for states as well as for remote sellers. Since October 1, 2005, over 600 retailers have **VOLUNTEERED** to begin collecting sales taxes for the member states, and these states have started to receive previously uncollected revenues for sales tax on transactions made through out-of-state retailers.

I believe that you will agree, that this effort to streamlined sales tax collection has been unprecedented in our history. In less than six years, the states working together with the support and assistance of the private sector, developed a new sales tax system that was fairer, simpler, more uniform and is technologically applicable; 21 states, almost half of all the states with a sales tax, enacted legislation to comply with these changes; and, the system is working. It is operational! <u>However, our work to establish a truly seamless system is only half done. It is now Congress' turn to act.</u> The states through the Streamlined Sales and Use Tax Agreement have provided Congress with the justification to allow states that have complied with the Agreement to require remote sellers to collect those sales' taxes as was intended in the *Quill* decision.

The Sales Tax Fairness and Simplification Act, S. 2152, as introduced by Senator Mike Enzi of Wyoming, embodies all the simplification requirements of the Streamlined Sales and Use Tax Agreement and provides certainty for taxpayers, retailers and other businesses that the states cannot backtrack on simplifications but if we do, the prohibition of the *Quill* decision will be reinstated.

NCSL supports S. 2152 because the legislation:

- provides for a national small business exception so that sellers with less than $5 million in taxable remote sales would be exempt from collection requirements;
- ensures reasonable and adequate compensation for all sellers for the cost of collection;
- provides certainty to taxpayers and sellers by allowing for an appeals process that includes review of the decisions of the Governing Board of the Streamlined Sales Tax System by the United States Court of Federal Claims;

- ensures that any filings by sellers in the course of registering, calculating, collecting and/or remitting sales and use taxes collected cannot be used as a criterion for determining nexus for any other tax responsibilities, including state business activity taxes; and
- ensures that the Agreement simplifications are applied to the administration and collection of transactional taxes on telecommunications services.

On behalf of my colleagues across the country, I would urge the Congress to adopt this legislation and send it to the President for his signature. You have the opportunity to not only ensure the future vitality of our states' major consumption tax, but you also will establish a level playing field for all retailers and help to provide $6.8 billion a year in relief to American retailers. Instead of spending this money to collect state and local sales taxes, these business can re-invest these funds into our states' and nation's economy.

Misconceptions and Misstatements

Over the last six years, as we have worked to develop a simplified and fairer sales tax system, we have heard criticisms and arguments against streamlining and against Congress setting aside the *Bellas Hess* and *Quill* decisions. I would like to take a few moments to correct some of the misconceptions that our opponents have made, some of which I am sure will be expressed this morning.

Myth: *"The Streamlined Sales Tax Agreement does not simplify tax compliance for retailers."*

Fact: Even if states did nothing more than adopt the proposed administrative changes contained in the Streamlined Sales and Use Tax Agreement, all retailers will benefit from reduced complexity. Opponents contend that rates are the biggest complication, but even Robert Comfort, Vice President for Tax Policy at Amazon.com, told a congressional hearing in 2001, "...rates are not a problem for Amazon.com." Sellers have testified over and over that the real burdens with collection are not sales tax rates but the different

product definitions from state to state, different state and local tax bases and the different rules and administrative procedures for registering, collecting, filing and remittance of sales taxes.

Under the Agreement, the certified automated system calculates the sales tax to be collected not the merchant, based upon the delivery address submitted by the consumer. All merchants that collect sales taxes using the state certified automated technology would be held harmless for any miscalculations. The state assumes the liability from the merchant, who under the current collection system bears total liability. The merchant would only be held liable for under-collection, if the merchant tampered with the certified technology or fraudulently failed to remit the sales taxes collected.

Myth: "*The Agreement will pose a threat to consumer privacy.*"

Fact: The Streamlined Sales and Use Tax Agreement has strong provisions that will protect the privacy of all consumers. The Agreement provides that a certified service provider "shall perform its tax calculation, remittance, and reporting functions without retaining the personally identifiable information of consumers." The only time that a certified service provider is allowed to retain personally identifiable information is if the buyer claims an exemption from taxation.

The Agreement requires the certified service providers to retain less information than is currently captured by VISA, MasterCard, American Express, Discover, or any other credit card company when a consumer makes a purchase and these companies can use this information for marketing purposes. If certified providers use or sell any information gathered from calculating sales taxes, they would lose certification to be a collector.

Let me set the record straight; the only information maintained by the vendor or third party collector for sales tax calculation are product, price, zip code, and sales tax

collected. Unless the consumer is the only person living in the zip code, no one would know who the consumer is!

Myth: *"The Agreement will force states to forfeit sovereignty over tax policy to out-of-state bureaucrats."*

Fact: No, the Streamlined Sales and Use Tax Agreement does not force any state to forfeit its sovereignty. Compliance to the Agreement is always optional for a state. The decision to comply with the Agreement can only be made by the state legislature and governor—and they can withdraw at any time.

Each state that complies with the Agreement will have one vote on the Governing Board of the Agreement. Each state that complies with the Agreement can have a delegation of up to four people with the state legislature in each state deciding who represents the state. In many cases, state legislators and tax administrators have been designated to serve on the Governing Board. The Agreement protects the sovereignty of each state to decide who represents them.

The Agreement also requires a 60-day notice on amendments that must be sent to the governor and the legislative leaders of each member state; the same governor and legislative leaders who have appointed the delegates to the Governing Board. The Streamlined Sales Tax Governing Board cannot change any state's sales tax statute, only the state legislature and the governor have that authority and nothing in the Agreement abrogates that authority.

Myth: *"The Agreement and federal legislation to require remote sales tax collection would violate the Constitutional doctrine of federalism. It would force businesses in states where the legislatures have chosen not to join the system or do not have a sales tax to collect sales taxes for other states."*

Fact: The Streamlined Sales and Use Tax Agreement does not in anyway violate the Constitution and is actually a vibrant example of federalism. The Agreement is voluntary

for states and for merchants, this is not a mandatory compact or violation of the Commerce Clause of the Constitution. The states voluntarily participated in the process to formulate the Streamlined Sales and Use Tax Agreement by enacting legislation by the people's elected representatives in each state, signed by the governor. The Agreement ratified by the states' delegates, responds to the challenges raised by the Supreme Court in two decisions, *Belles Hess* and *Quill*, and provides a blueprint for Congress to overturn these decision.

Should Congress grant states remote sales tax collection authority if they comply with the Agreement, then businesses that are located in a state that chooses not to comply with the Agreement or that has no sales, tax would only be subject to collection requirements under the Agreement if that seller chooses to sell into a state in which the legislature has decided to comply with the Agreement. Opponents exclaim fear that *"This implicates profound practical and theoretical federalism concerns."* However, no seller is forced to sell into states that comply with the Agreement. Out-of-state sellers make that decision and in doing so, they also make themselves liable to the other state's non-sales taxes statutes and regulations protecting consumers and conducting business. An insurance company domiciled in Illinois must follow New Hampshire's insurance laws when doing business in New Hampshire, the same for banks and many other interstate businesses.

Myth: *"The Agreement will reduce tax policy competition between the states."*

Fact: No. As I have stated many times, the state legislature in each state that complies with the Streamlined Sales and Use Tax Agreement will still decide what is taxed, who is exempt and at what rate it wants to tax transactions. How is tax competition eliminated by simplified administrative efficiency or even uniform product definitions? In fact, the competitive strength of America's businesses would be enhanced by reducing the regulatory complexity, costs and burden of the current state sales tax collection system on businesses. Who could oppose reducing or eliminating the current $ 6.8 billion a year it costs American retailers to collect our sales taxes?

The Streamlined Sales and Use Tax Agreement is a prime example that states are "laboratories of democracy." States working together have developed a solution to ensure the viability of a major revenue stream while eliminating the burden, complexity and cost on retailers to collect the states' sales taxes and maintaining state sovereignty for tax policy. State legislators and governors are finding ways to maintain vital government services such as education, health care, public safety and homeland security while ensuring the viability of America's businesses in a global marketplace.

Myth: "*The Agreement will impede the success of electronic commerce. Collecting sales taxes on electronic commerce transactions is a new tax.*"

Fact: Under the Streamlined Sales and Use Tax Agreement, the buyer making a transaction will not need to fill out any additional forms in order for the sales tax to be calculated or collected. The tax is determined by the delivery address, and anyone who is buying a tangible product online wants to make sure that the product is delivered to the right address. The consumer fills out only one address field. In cases of digital products like online books or movies, the online seller wants to be paid and they will not accept a credit card payment without address verification. Once again, no additional tax form would be required.

A study released by Jupiter Research in January 2003, "*Sales Tax Avoidance Is Imperative to Few Online Retailers and Ultimately Futile for All,*" found most people are unaware that they are not paying sales taxes when they make a purchase over the Internet. In the same study by Jupiter, only 4 percent of online buyers said that the collection of sales and use taxes would always affect their decision to buy online.

The effort to streamline sales tax collection is not a new tax on electronic commerce. Online sellers already collect sales taxes where they have nexus. The effort of states to streamline sales tax collection will only remove the burden from all sellers in collecting a tax already levied by state and local governments.

Myth: *"The University of Tennessee's study on revenue loss for states due to remote sale transactions is not accurate. The estimates of revenue loss are too high."*

Fact: The Business and Research Center at the University of Tennessee issued its first study on potential revenue loss due to transactions that occur through remote sellers, including electronic commerce in 2001. This study was updated in July 2004 at the request of the National Conference of State Legislatures and the National Governors Association. The updated study shows that the estimates of potential revenue loss was not as high as first predicted. The authors of both studies, Dr. Donald Bruce and Dr. William Fox, provided the following explanation for the difference in estimates between 2001 and 2004: " The experience of the last several years indicates that e-commerce has been a less robust channel for transacting goods and services than was anticipated when we prepared the earlier estimates. The findings provided here are based on lower estimates of e-commerce, and the result is a smaller revenue loss than we previously indicated. Our loss estimates are also lower because many more vendors have begin to collect sales and use taxes on their remote sales. Still, the Census Bureau reports a combined $1.6 trillion in 2002 in e-commerce transactions by manufacturers, wholesalers, service providers, and retailers, and Forrester Research, Inc.'s expectations continue to be for a strong growth in e-commerce in coming years. Thus the revenue erosion continues to represent a significant loss to state and local government."

Myth: *"The Agreement will widen the digital-divide, because it will disproportionately impact rural, low income, disabled or even elderly buyers."*

Fact: If brick and mortar stores are not as accessible in rural areas as they were say, ten years ago, perhaps they no longer can afford to compete with the price advantage enjoyed by online/remote sellers that do not collect sales taxes. When brick and mortar stores in rural areas are forced out of business that means the rural farmer will have to pay higher property taxes on his farm or increased state income taxes. Higher property or income taxes, just so that one can buy a book or CD on-line sales tax free?

Opponents imply that the streamlined sales tax effort will "*have the effect of widening the so-called "digital divide.*" Unfortunately, they fail to show an equal concern for those hard working Americans who may lack the credit or the ability to shop on-line because of a lack of access to the Internet or even a computer. These Americans are paying the sales tax every time they make a purchase in a local brick and mortar store. However, those consumers who have sufficient credit, home computers and access to the Internet are able to avoid the sales tax with almost every online purchase. In truth, if the states fail to simply their sales tax systems and Congress fails to give states that comply with the Agreement remote sales tax collection authority, the consequences will be the greatest for low income Americans who do not have the resources to shop out of state.

Myth: *"The Agreement is a good concept but it can never really work."*

Fact: Since the Streamlined Sales Tax System became operational on October 1, 2005, over 600 remote sellers have volunteered to begin collecting sales taxes for those states that have complied with the Agreement. The certified service providers were approved in May and even before the certified automated system was online and available to sellers, these sellers had started to collect sales tax and remit those taxes to the states. The Streamlined Sales Tax System is so much simpler that without even the software in place, remote sellers could begin collecting sales taxes on transactions made by residents of these states.

Conclusion

In closing, I would like to reiterate for the members of this Subcommittee that twenty-one states have enacted compliance legislation and many others have enacted some of the changes needed to comply with the Agreement. I believe we are at a point that if Congress fails to act soon on the federal legislation as envisioned in the Sales Tax Fairness and Simplification Act by Senator Enzi, the momentum in the remaining states will slow. In some of these states, compliance to the Agreement may require politically difficult changes to the sales tax statutes. Congressional approval of this legislation will

help the legislatures in those states make the necessary changes. As I stated previously, states have made unprecedented progress to eliminate the burdens and costs to retailers that the *Quill* decision outlined. It is now Congress' opportunity to ensure that the simplified system that the states have developed for the seamless collection of transactional taxes in the new economy is not impeded by those who merely are trying to avoid paying legally imposed taxes.

Thank you.

Questions for the Record From Hon. Christopher Rants
July 25, 2006

From Senator Hatch:

1. Mr. Isaacson mentioned in his written testimony that he believes the Streamlined Sales and Use Tax Agreement has failed to reduce, in any meaningful way, the burdens of tax collection, reporting, remittance and audits for interstate marketers. What do you say in response to this?

The Streamlined Sales and Use Tax Agreement (Agreement) is a success. The Agreement has resulted in 21 states substantially reducing the burdens of tax collections, reporting, remittance and audits by adopting: uniform product definitions, including for food and related items; uniform state and local tax base; uniform returns and remittances; uniform audit procedures; uniform privacy protections; uniform sourcing (except for Utah, Tennessee and Ohio), including the sourcing of telecommunications services and definitions; uniform administrative definitions; uniform rounding rule; simplified exemption administration; and by reducing the number of tax rates; establishing central sales tax collections and administration; eliminating caps and thresholds on rates; and standardizing sales tax holidays. In those states, businesses are faced with a uniform sales tax system. The recognition that 21 states have the same definition for a "food product" or "delivery charge" is a monumental accomplishment in itself. In addition, the availability of a certified service provider, or CSP, coupled with liability relief for businesses, significantly reduces the burden businesses, especially small retailers, face in the collection and remittance of state sales taxes. These accomplishments and the benefits the Agreement bestow cannot be overstated.

2. Mr. Noble indicated that 42 states and the District of Columbia all participated in the Streamlined Sales Tax Project. However, according to Senator Enzi, only 19 states have enacted the legislation to participate. Can you describe for us the process for states in fully joining in the project and why you believe many states have been slow to participate?

How does a state join the Streamlined Sales and Use Tax Agreement?
A state may petition the Streamlined Sales Tax Governing Board (Board) to join the Streamlined Sales and Use Tax Agreement (Agreement) at any time. The petitioning state must certify to the Board that are compliant with the terms of the Agreement, provide documentary evidence of such compliance and propose a date for entry. The Board may, by a ¾ vote of the member states, approve a states petition for membership under the Agreement if the petitioning states laws, rules, regulation, and policies are substantially compliant each of the requirements of the Agreement. Substantial compliance entails a state adopting the aforementioned simplifications (see Answer #1).

Why have some state been slow to participate?
The continued growth of the project and the long-term viability of the Agreement is at the discretion of Congress. As stated by the United States Supreme Court, Congress has the authority to authorize states to require businesses to collect sales tax on remote sales. Without Congressional action, the Agreement remains a voluntary effort. To date, twenty-one states are compliant with the Agreement. Of the 42 states that participated in the Streamlined Sales Tax Project, the majority of those states have been involved with the Agreement as advisor states to the Streamlined Sales Tax Governing Board, the organization which is charged with the administration of the Agreement. However, without Congressional action, the Agreement remains a voluntary project. Businesses voluntarily collect sales tax on remote sales.

Once Congress grants the states the authority to require businesses to collect sales tax on remote sales, as contained in the Sales Tax Fairness and Simplification Act, introduced by Senator Mike Enzi of Wyoming, more states will take action to simplify their sales tax collections and administration. States that may have been slow to enact the simplification requirements as contained in the Agreement will take those steps in accordance with the authority granted by Congress.

I urge Congress to adopt the Sales Tax Fairness and Simplification Act and grant states the authority to level the playing field for all businesses and consumers.

Statement from Senator Rockefeller

Mr. Chairman, thank you very much for having this hearing. As a former governor of my state, I am aware of how difficult the job of governor is. And while collecting taxes is certainly not the most pleasant aspect of that job, it is necessary. Governors work very hard to make taxes fair and efficient. The current system for sales tax collection on internet transactions is neither fair nor efficient. I am very anxious for this committee to explore solutions to the problem.

Technology has changed the way that Americans live -- the way we communicate and shop and do business. It is difficult for government to keep pace with technology and update our policies to address the changes. But Congress needs to take this task very seriously. Many states, including my home state of West Virginia, have worked very hard to simplify and rationalize their state sales taxes in order to reduce the collection burden for online merchants. Congress must now address this issue and make sure that the states' hard work is not in vain.

Senators Enzi and Dorgan have presented very similar bills that could protect the ability of states to collect taxes in a reasonable and efficient way. The status quo is unfair to traditional, so-called bricks and mortar, stores that collect sales tax while their competitors do not. And the system is unsustainable, because states will lose more and more revenue as commerce shifts to the internet.

Recently, this committee passed legislation to make permanent the internet access tax moratorium. When we did so, I fear we did not give adequate consideration to the adverse consequences that legislation may have on state revenues. It is not that states want to tax internet access, but the law may prevent them from collecting traditional taxes on telephone services.

I am pleased that today the committee is taking the time to examine the implications of internet technology for the collection of traditional sales taxes. It would be irresponsible for Congress to ignore this issue any longer.

I look forward to working with the members of this committee and with Senators Enzi and Dorgan to address the problem. Thank you, Mr. Chairman.

Senator Charles E. Schumer

Opening Statement
Finance Subcommittee Hearing on the
"Business Activity Tax Simplification Act of 2006"

July 25, 2006

Thank you, Mr. Chairman. I want to say a few words about the bill I have introduced with Senator Crapo and others, the "Business Activity Tax Simplification Act of 2006," which is scheduled for a vote on the House floor later today.

Our bill tries to solve a very important question involving how states should tax businesses that locate their operations in a few states, but have customers and earn income in many states. These companies are facing a confusing and costly assortment of state and local tax rules, some enacted by legislatures and others imposed upon them by state revenue authorities.

A majority of states impose corporate income and other so-called "business activity taxes" only when companies have "physical presence," such as employees or property, in their states. However, tax administrators in some states contend that the mere presence of a business's customers, merely "economic presence," in their states is all that is necessary to impose a BAT. These differences in tax theories lead to uncertainty, litigation and, in many cases, double taxation. I have spoken out against double taxation on many issues, from the tax on dividends to the payroll tax, and the double tax in these cases – while not as large – is just as wrong.

I believe Congress has a responsibility to create a uniform nexus standard for tax purposes so that goods and services can flow freely between the states. Firm guidance on what activities can be conducted within a state that will trigger a state's taxing power will provide certainty to tax administrators and business, reduce multiple taxation of the same income, and will reduce compliance and enforcement costs for states and businesses alike.

S. 2721 does this by requiring a business to have a physical presence in the state before it can be subject to state business activity taxes. Under BATSA, mere economic activity – such as in-state customers, or the transportation of goods on a state's highways, or the hosting of a website on a server in the state – would be insufficient for a state to impose income and other business activity taxes on out-of-state businesses.

The physical presence standard is a workable and uniform definition for all states and industries. Once the bill becomes law, states will still be free to offer incentives for businesses to locate new facilities and create jobs within their borders. Nothing in our bill prevents a state from offering these incentives – and nothing in our bill prevents states from enforcing its own tax shelter laws on businesses that try to play games to reduce their tax liabilities.

In most cases, this bill creates a win-win. For smaller businesses facing different taxing standards in different states, BATSA would eliminate costly litigation and administrative issues. For many larger companies that have customers throughout the country, the legislation creates clarity and reduces the likelihood of double taxation. For the states, the bill creates a uniform taxing standard that permits them to compete on a level playing field for business activity and jobs, while establishing a predictable and relatively easily discernable tax base.

I understand that there have been some concerns raised about the bill, most notably about the federalism issue, and the claim that the bill will cost state and local governments a relatively small amount of revenue. My response to that is twofold. First, under current law, while some states may be gaining, business is losing as a result of the huge administrative costs imposed on them by current law. Second, if a state needs to make up a small amount of lost revenue, they will have the power to do so by taxing individuals and businesses that have an appropriate physical presence in the state.

In other words, the fact that a state may lose a small amount of revenue under BATSA is an insufficient argument for maintaining the status quo, where another state can tax a New York company simply because it has a customer or client in that state.

My state of New York serves as the headquarters for some of the world's largest companies, and New York enjoys significant tax revenue by imposing business activity taxes on companies based there. But New York is also the headquarters for many medium and small businesses in all types of industries. Most of these companies, large and small, have customers not only in other states, but also throughout the world. It simply makes no economic or logical sense for some other states to assert taxing jurisdiction over these very same companies simply because they have a nationwide customer base.

S. 2721 is the best way I can see to resolve this issue of nexus for tax purposes. I also know that there are other views. I look forward to hearing the panel discuss whether our bill is the right answer or, if not, what might be a better way to resolve what is becoming a significant problem for taxpayers and state tax administrators.

Thank you, Mr. Chairman.

Statement of Olympia J. Snowe
Subcommittee on International Trade
of the Committee on Finance
How Much Should Borders Matter?: Tax Jurisdiction in the New Economy
July 25, 2006

Mr. Chairman, thank you for holding this hearing to examine the the Streamlined Sales & Use Tax Agreement and Business Activity Taxes. I would also like to thank our distinguished panel of witnesses for testifying today and would like to especially welcome my friend, George Isaacson, from Lewiston, Maine. George has had a distinguished career and has become a leading authority through his legal practice on state sales, use and income tax matters especially as they relate to direct marketers and electronic merchants.

Located in the most northeastern corner of the country, the Internet has enabled Maine businesses, as well known as LL Bean and many smaller specialty retailers such as Look's Gourmet Food Company, reach customers throughout the country and the world. I believe that growth of the Internet has had a tremendously positive affect. It is has increased competition, consumer choice and lower prices. As a result, I supported the Internet Tax Freedom Act in 1998 and its extensions in 2001 and 2003. This act not only prohibits taxation of internet access, but also prohibits multiple or discriminatory taxation on Internet commerce.

I understand the need of local and state governments to raise revenues. I also understand the complexity and cost burdens that imposing taxes on remote businesses would cause. We, then, must achieve a delicate balance to allow state and local governments to appropriately to levy taxes, and therefore raise revenues, and to fulfill Congress' Constitutional obligations to regulate and promote interstate commerce.

Mr. Chairman, I would like to thank you again for holding this critical hearing. We need to enforce our Constitutional obligations with respect to interstate commerce and ensure that it isn't unduly burdened given the new realities of our economy. Thank you.

United States Senate

WASHINGTON, DC 20510–5003

Statement of Senator Craig Thomas, Chairman
Subcommittee on International Trade

Hearing on
How Much Should Borders Matter?: Tax Jurisdiction in the New Economy

July 25, 2006

Rapid technological advancement has greatly facilitated the conduct of commerce across both interstate and international borders. Geographic borders have consequently become increasingly artificial. Consumers can now just as easily purchase products directly from New Zealand as New Jersey, and businesses can reach customers all over the world from a single location – or no tangible location at all.

These developments have given rise to whole new sets of issues that have not previously existed. Historically, states were able to reasonably approximate taxing economic activity within the state by taxing businesses that were physically located within its borders and imposing on those same businesses the obligation to collect sales taxes from consumers.

The common underlying question we face today is whether traditional physical presence based on geographic borders is still the most appropriate standard for tax jurisdiction, and, if not, what is the proper standard?

We examine this question today in two separate contexts. The first arises as a result of increasing interstate and international commerce over the Internet. Current law requires that a seller be physically located in the state for the state to be able to impose sales tax collection responsibility. When a state resident makes a purchase directly from an out-of-state seller and sales tax is not paid on the transaction, the purchaser is generally responsible directly to the home state for the tax obligation. However, in practicality, it is almost completely impossible for the states to enforce this obligation. This issue is not a new one, as it also applies to catalog sales, but its importance has grown as Internet commerce has increased.

As a result of concern over lost state and local tax revenue, the states proposed legislatively shifting the sales tax collection burden to the remote seller. The problem of thousands of different tax jurisdictions, each with varying rates, definitions, and procedures for change, made that all but impossible. The states attempted to address these issues by developing the Streamlined Sales Tax Project to try to achieve uniform rates and definitions. The project began in March 2000, and the original agreement was approved in November 2002.

Senators Enzi and Dorgan have each introduced substantially identical legislation that would legislatively shift the burden of sales tax collection to remote vendors. However, many in the business community are concerned that, as drafted, the simplification threshold has been set too low for this duty to be feasibly carried out.

The second issue we are here to examine is business activity taxes (BAT) that are imposed directly by states on businesses or individuals, measured by receipts, income, or profits. The Supreme Court has established that there must be substantial nexus for the state to be able to exercise taxing jurisdiction over an entity, but it is unclear exactly what constitutes "substantial nexus." In recent years, some states have become more aggressive in their quest for revenue and are asserting increasingly tenuous grounds for nexus.

A number of states are taxing non-resident athletes and performers based on as little as a single game or performance within the state. Some states have also attempted to collect BAT on the basis of trucks passing through the state – even without picking up or delivering goods – or on the basis of a web server or telephone listing. As each state operates by its own rules, the haphazard and uncoordinated imposition of BAT can result in taxation of the same income by multiple jurisdictions.

In response to concerns raised by businesses and individuals regarding nexus certainty, Senators Schumer and Crapo introduced legislation to establish that physical presence is required to provide sufficient nexus for BAT taxing jurisdiction. The states generally oppose this position because they believe physical presence is no longer a reasonable approximation of the economic activity taking place within the state.

The issues raised here are far-reaching – from encouraging healthy competition for investment between various domestic and international jurisdictions, to ensuring that states do not engage in activity that discriminates against interstate business. As a country that values its federalist system, we must take care to guard a state's ability to establish its own laws and exercise appropriate taxing jurisdiction, while at the same time ensuring that there is a clear line delineating where competition ends and discrimination begins.

COMMUNICATIONS

AMERICAN LEGISLATIVE EXCHANGE COUNCIL

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"How Much Should Borders Matter?: Tax Jurisdiction in the New Economy"

United States Senate
Committee on Finance
Subcommittee on International Trade
July 25, 2006

Testimony for the Record

The Honorable Jamie Van Fossen
81st District Representative
Iowa House of Representatives
&
Public Sector Chairman
Tax and Fiscal Policy Task Force
American Legislative Exchange Council

Introduction

Chairman Thomas:

Thank you for the opportunity to provide written comments in conjunction with today's hearing, "How Much Should Borders Matter?: Tax Jurisdiction in the New Economy."

I offer these comments in my capacity as a state legislator representing the 81st House District of Iowa, where I am serving in my third term as chair of the Iowa House Ways & Means Committee, and as a member of the American Legislative Exchange Council (ALEC). ALEC is the nation's largest nonpartisan, individual membership organization of state legislators, with over 2,400 members across the nation. In addition, I serve as the Public Sector Chairman of ALEC's Tax and Fiscal Policy Task Force.

Streamlined Sales Tax and Business Activity Tax

Before the subcommittee are two very distinct issues – the Streamlined Sales Tax (SST) Project and business activity taxes (BAT) – that both concern the issue of "nexus," or the appropriate jurisdictional standard for collection and remittance of taxes. It should be noted, however, that the two issues are largely unrelated. The Streamlined Sales Tax Project represented an effort by states to form an interstate compact to develop uniform rates and definitions for the collection and remittance of sales and use taxes, while business activity taxes concern direct corporate taxation (income, franchise, gross receipts, etc). These differences may seem inconsequential, but they are important to a great number of state legislators across the country.

ALEC's policy positions on SST and BAT reflect the important distinctions between these two issues. In 2003, ALEC adopted a resolution (attached) urging Congress to reject authorization of the Streamlined Sales Tax Project because legislators were extremely concerned that federal legislation would overturn the U.S. Supreme Court's 1992 *Quill* decision (*Quill v. North Dakota,* 504 U.S. 298) and allow states and localities to force vendors without physical presence to collect sales and use taxes on catalogue, Internet, and other sales. Lawmakers from states that chose not to join the Streamlined Sales Tax Project have also raised concerns that federal legislation such as the Enzi or Dorgan bill would empower participating states to impose their tax collection burden on out-of-state businesses even in non participating states. ALEC members, many of whom represent states that are in the process of conforming with the SST and support the stated goals of simplicity and uniformity, believe that federal legislation would violate the constitutional principles of federalism and state sovereignty.

ALEC legislators wholeheartedly endorse federal legislation that would establish a physical presence nexus standard for business activity taxes. Speaking from my own experience, the people of the 81st House District elected me to represent their interests in the Iowa General Assembly. Part of that responsibility is to ensure that our state develops a business climate that expands opportunities for our existing companies and attracts new business investment. As a state legislator, however, there is only so much I can do to help develop a solid business climate

in Iowa. Many of the companies in my district do business all over the United States and the world, which is good for my state and my constituents. However, many Iowa-based businesses find that the hospitality in other states is not as warm or friendly as it is in Iowa. There have been an increasing number of lawmakers and revenue officials in other states who have become quite aggressive in their efforts to raise revenue from out-of-state businesses. This is an obstacle to interstate commerce that is hurting states and businesses alike.

In 2003, ALEC's Tax and Fiscal Policy Task Force unanimously approved a model resolution (attached) calling on Congress to protect and expand the physical presence requirement for the state collection of business activity taxes. Our resolution states in part:

> "...the physical presence standard promotes fairness by ensuring that businesses that receive benefits and protections provided by state and local governments pay their fair share for these services"; and
>
> "...the ability of state and local jurisdictions to tax out-of-state businesses should be limited to those situations in which the business has employees and/or property in the taxing jurisdiction and accordingly receives meaningful governmental benefits or protections from the jurisdiction..."

ALEC supports this approach because it is consistent with our Jeffersonian principles. States should not be able to tax those companies that are not physically present in their state. A more expansive standard would subject businesses to higher taxes, costly litigation, and as a result, less capital to invest and grow the economy.

I know some of my colleagues in other state groups have a different opinion about this issue and the bills that have been introduced in the 109th Congress – H.R. 1956 and S. 2721. I would like to take just a moment and address the concerns that have been raised - in particular, concerns over tax revenue losses, preemption of state tax authority and tax sheltering.

First, opponents of the physical presence standard suggest that it will lead to substantial revenue loss for the states. The revenue effect is often overstated. The CBO cost estimate found that foregone state tax revenue would amount to less than 2 percent of total business activity taxes collected. A recent Ernest & Young report concluded that the revenue loss would equal 0.8 percent of total state and local business activity taxes and .01 percent of total state tax revenue. This is a small opportunity cost to restoring fairness and transparency to the tax code and protecting businesses from unwarranted out-of-state tax collection. If my counterparts in other states want to raise more taxes from corporations, they should do so by encouraging them, through lower taxes and other means, to locate in their state or by raising taxes on their own companies—not by coercing them to pay taxes even when they are not physically present in their state. This is what tax competition is all about.

Some state-based organizations have said that H.R. 1956 and S. 2721 would represent one of the largest preemptions of state taxing authority in the history of the Republic. The Commerce Clause of the Constitution and subsequent court decisions have placed limits on state tax authority over non-resident corporations and individuals, so neither H.R. 1956 or S. 2721

encroach on state sovereignty or prevent states from taxing companies that have a presence in their own state. ALEC members strongly believe in federalism and state sovereignty and understand that federal legislation in this area is necessary to protect our states and constituents from over-aggressive state tax collectors.

Opponents of the federal BAT legislation have also insinuated that it will encourage tax sheltering. I will respectfully disagree with my colleagues and state organizations who believe that H.R. 1956 and S. 2721 will make tax sheltering worse. It is important to remember that a tax shelter is in the eye of the beholder. The U.S. Constitution is certainly not a tax shelter. I believe the physical presence rule best embodies the principles that we find in our Constitution and our laws, and I am baffled at the repeated assertions that federal legislation would only serve to open up our states to more corporate tax sheltering. Even if they were right, states have the tools to fight abusive tax shelters. Sham transactions and those that lack economic substance can certainly be fought even if H.R. 1956 or S. 2721 becomes law. Furthermore, lawmakers in other states are moving forward with a number of new measures to fight tax shelters. Let me assure you that the arsenals that states have in our battle against tax shelters will remain virtually intact if Congress adopts H.R. 1956 or S. 2721.

Conclusion

Mr. Chairman, thank you for the opportunity to represent my views and the views of ALEC. As a former state legislator member of ALEC, you are keenly aware of its interest in promoting free markets, limited government, and individual liberty. Given our long-standing interest in the issues being discussed today, we thank you for scheduling this hearing. We look forward to working with you and your colleagues in the days and months ahead to enhance states' business climate through a limited government approach.

Resolution Urging Congress to Reject Authorization of the Streamlined Sales Tax Project (SSTP)

Summary

A number of states have enacted authorizing legislation to join the Streamlined Sales Tax Project (SSTP). SSTP is an effort to streamline the sales and use tax base and rate among the states, with a goal to lessening the sales and use tax collection burden of businesses. In addition to streamlining sales and use taxes, SSTP seeks to lobby Congress to overturn the Quill decision, which held that the Commerce Clause of the U.S. Constitution forbids states from forcing out-of-state sellers to collect sales and use tax on its behalf. While the goal of SSTP is laudable, the means chosen violate the constitutional principles of federalism and state sovereignty, and Congress should reject SSTP authorization on these grounds.

Model Legislation

WHEREAS, the advent of the Internet has led to a number of collection issues in state and local sales and use tax collection, and;

WHEREAS, similar collection issues in state and local sales and use tax collection were encountered previously in the area of catalogue sales, and;

WHEREAS, the Supreme Court of the United States correctly held in Quill v. North Dakota, 504 U.S. 298 (1992), that the Commerce Clause of the U.S. Constitution forbids a state or locality from forcing a vendor to collect sales or use tax on its behalf unless the vendor has physical presence in the state, and;

WHEREAS, the Quill decision is equally applicable to Internet sales, and:

WHEREAS, sales and use tax in many states is already applicable to Internet sales, and;

WHEREAS, a vendor should collect sales and use tax on Internet sales in those states where the vendor has physical presence, and;

WHEREAS, current law allows for the taxation of Internet sales where the Constitution allows such taxation, and:

WHEREAS, federalism and state sovereignty are among the many important principles underlying the Constitution of the United States, and;

WHEREAS, the movement known as the Streamlined Sales Tax Project (SSTP) calls upon Congress to overturn the Quill decision and allow states and localities to force vendors without physical presence to collect sales and use taxes on catalogue, Internet, and other sales, and;

WHEREAS, the SSTP would thus allow many states to improperly impose their tax burden on out-of-state businesses and citizens who do not otherwise pay taxes, enjoy services, or have the ability to influence policy decisions in other states, and;

WHEREAS, the SSTP would force many states to standardize their sales and use tax systems and sanction those states that are found to be non-compliant with the SSTP, and;

WHEREAS, the SSTP would thus dilute the power of state officials to shape and manage tax policy, because pressure would be exerted to conform with the standards adopted by the SSTP governing board;

NOW THEREFORE LET IT BE RESOLVED, that the state of [Insert State] calls upon Congress to reject authorization of the SSTP, on the grounds of protecting the constitutional principles of federalism and state sovereignty, and maintain the Quill decision as the proper constitutional basis for out-of-state vendor collection of sales and use tax on a state's behalf.

Adopted by ALEC's Tax and Fiscal Policy Task Force at the Annual Meeting August 1, 2003. Approved by full ALEC Board of Directors August, 2003.

1129 20th Street N.W. ■ Suite 500 ■ Washington, D.C. 20036 ■ Tel. (202) 466-3800 ■ Fax (202) 466-3801 ■ www.ALEC.org

Resolution on State and Local Business Activity Taxes

WHEREAS, the United States Supreme Court, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), held that remote sellers lacking a physical presence may not be required to act as tax collection agents of the state; and

WHEREAS, direct state and local taxes on business, also known as "business activity taxes," such as income, franchise, net worth, business license, business and occupation, single business, capital stock, and like taxes, impose an even greater burden on businesses engaged in interstate commerce than an obligation to collect a tax from consumers; and

WHEREAS, the physical presence standard promotes fairness by ensuring that businesses that receive benefits and protections provided by state and local governments pay their fair share for these services; and

WHEREAS, the ability of state and local jurisdictions to tax out-of-state businesses should be limited to those situations in which the business has employees and/or property in the taxing jurisdiction and accordingly receives meaningful governmental benefits or protections from the jurisdiction; and

WHEREAS, the physical presence standard results in the proper attribution of business profits to taxing jurisdictions where a business is located and thus does not result in tax avoidance; and

WHEREAS, a business activity tax filing requirement based on a standard other than physical presence results in increased filing requirements and thus increased compliance costs; and

WHEREAS, businesses currently rely on a physical presence standard for complying with state and local business activity tax obligations, and this standard is applied currently by most state courts; and

WHEREAS, any Congressional authorization for states to impose a sales and use tax collection obligation would further put businesses at risk of the unfair application of business activity taxes by jurisdictions in which the businesses lack a physical presence; and

WHEREAS, the imposition of a standard other than physical presence for business activity taxes would expose U.S. companies lacking a physical presence overseas to similarly expansive and unfair taxation by foreign countries and their provinces; and

WHEREAS, businesses operating in interstate commerce should not be compelled to pay taxes in state and local jurisdictions solely as a result of the business having customers located in the taxing jurisdiction; and

WHEREAS, the United States economy has become more global since Congress first enacted Public Law 86-272 and has shifted toward the provision of more interstate services and intangibles, and providers of services and intangibles are competitively disadvantaged relative to businesses that only sell tangible personal property;

AND WHEREAS, the enactment of new business activity taxes other than income taxes threatens to circumvent the intent of Congress in enacting Public Law 86-272;

NOW, THEREFORE BE IT RESOLVED, That the state of ______ urges Congress to enact legislation 1) recognizing a physical presence standard for the imposition of state and local business activity taxes, 2) defining de minimis standards for measuring physical presence and setting reasonable limits on the attribution of nexus, and 3) updating Public Law 86-272 to extend the current protections available for the solicitation for sales of goods to the solicitation for sales of services and intangibles and to apply these protections to all business activity taxes; and

BE IT FURTHER RESOLVED, That the state of ______ recognizes that any Congressional approval of "sales tax streamlining" without the simultaneous enactment of these business activity tax measures would have a harmful effect on American businesses and the economy.

Adopted by ALEC's Tax and Fiscal Policy Task Force at the Annual Meeting August 1, 2003. Approved by full ALEC Board of Directors August, 2003

AMERICAN LEGISLATIVE EXCHANGE COUNCIL

1129 20th Street N.W. ■ Suite 500 ■ Washington, D.C. 20036 ■ Tel. (202) 466-3800 ■ Fax (202) 466-3801 ■ www.ALEC.org

Statement for the Hearing Record

Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities
820 First Street, NE, Suite 510, Washington, DC 20002

"How Much Should Borders Matter? Tax Jurisdiction in the New Economy"

Subcommittee on International Trade, Senate Committee on Finance

July 25, 2006

A bill under consideration in both houses of Congress would take away from the states authority they currently have to tax a fair share of the profits of many corporations that are based out-of-state but do business within their borders. The proposed legislation is the "Business Activity Tax Simplification Act of 2005," (BATSA, S. 2721/H.R. 1956).

BATSA would impose what is usually referred to as a federally-mandated "nexus" threshold for state (and local) "business activity taxes" (BATs). State taxes on corporate profits are the most widely-levied state business activity taxes. The term also encompasses such broad-based business taxes as the Michigan Single Business Tax (a form of value-added tax) and the Washington Business and Occupations Tax (a state tax on a business' gross sales). The "nexus" threshold is the minimum amount of activity a business must conduct in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State business tax laws will set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must file a tax return and pay any tax that is owed. Federal statutes can override state nexus laws, however, and BATSA proposes to do just that. BATSA would create a number of new nexus "safe harbors" — categories and quantities of activities conducted by corporations in states that would be deemed no longer sufficient to establish BAT nexus for the corporation.

An earlier Center report provides an overview and analysis of the proposed legislation. (See: *Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy*, revised July 20, 2006, www.cbpp.org/9-14-04sfp.htm. Hereafter referred to as the "Center's analysis of BATSA.") That report focused on the adverse impact of BATSA on the revenue-raising capacity and fairness of state corporate income taxes.

This statement is devoted to addressing the key claims made by the proponents of BATSA as to why its enactment is necessary. Many of these claims go to the heart of the subject matter of this hearing: the appropriate state tax jurisdiction standards that ought to apply in our contemporary service-oriented, Internet-driven economy.

The following are the key arguments offered in support of the enactment of BATSA, paired with rebuttals.

Claims About Why the Bill Is Needed In General

Claim:

BATSA establishes a "physical presence" nexus threshold for state BATs. Such a threshold is fair, because businesses don't benefit from public services to any meaningful extent in states in which they don't have employees or facilities and therefore shouldn't be obligated to pay any BAT to such a state.

Rebuttal:

- BATSA does *not* establish a "physical presence" nexus threshold. A true "physical presence" nexus standard would provide that a corporation that has employees or property in a state is taxable there and a corporation that is not physically present is not taxable. In actuality, BATSA would allow corporations to have *unlimited* amounts of several categories of employees, agents, and property in a state without establishing nexus for business activity taxes. For example, the bill would allow a corporation to have an unlimited number of salespeople in a state using company-owned computers and driving company-owned cars without creating BAT nexus, as long as the salespeople worked out of their homes or visited from out of state.

- Such employees and property are clearly benefiting from state-provided services like roads and police protection, negating the fundamental rationale offered for BATSA.

- Out-of-state businesses often benefit substantially from public services provided by states in which they have no physical presence but do have customers, and can reasonably be expected to pay some amount of business activity tax to such a state. For example, when an out-of-state bank makes mortgage loans in a state, the value of the houses that serve as collateral on the loans depends critically on the quality of local schools where the home is located, and the collateral itself is protected by local police and fire services. Moreover, banks use the local court system to foreclose on the loans if borrowers don't repay. The provision of such services justifies the payment of some income tax by the bank to the states where its borrowers are located, notwithstanding its lack of a physical presence in such states.

- In most states the *amount* of income tax a corporation owes substantially depends on the amount of physical presence the corporation has in the state; the more employees and property, the higher the tax payment. That is appropriate under the "benefits received" principle of taxation, because businesses are likely to benefit more from public services the more workers and property they have in a state. But to suggest that a non-physically-present business should have *no* tax obligation to the state is unreasonable given the fact that it is earning income in the state and benefiting from services provided by the state.

- In its 1992 *Quill* decision, the U.S. Supreme Court said explicitly that a non-physically-present mail-order company that purposefully availed itself of a consumer market in North Dakota *was* benefiting sufficiently from public services provided by that state to be fairly required to collect and remit sales taxes to that state. The fact that the decision nonetheless upheld a "physical presence" nexus threshold for sales taxes was based on the court's desire to protect interstate commerce generally from excessive sales tax *compliance* burdens, not on the grounds of unfairness to the Quill Corporation itself.

Claim:

BATSA is needed to reverse state court decisions that have held that physical presence is not required for BAT nexus, because they likely were wrongly decided. In the 1992 *Quill* decision, the U.S. Supreme Court held that an out-of-state business must be physically present in a state before it can be required to collect and remit sales tax to that state. Logic demands that the nexus threshold for BATs be *at least* "physical presence," because a BAT is imposed directly on the business and comes out of the business' pocket, while a sales tax is merely collected from the customer by the business.

Rebuttal:

- The "physical presence" nexus threshold established in *Quill* was based on the Court's desire to protect interstate commerce from excessive sales tax *compliance* burdens, not on any concerns about the *economic* burden on the company itself. Sales taxes have a much greater potential to interfere with a business' engaging in interstate commerce than corporate income taxes and other BATs do, because a company that is obligated to collect sales taxes from customers on behalf of a state must engage in numerous activities before it makes a single sale. For example, it must register as a sales tax collector, it must identify every one of its products and its customers as taxable or tax-exempt, it must program its accounting system to charge its taxable customers the proper tax, and it must actually collect the tax from them and maintain records to demonstrate to an auditor that it has done so. In contrast, the only thing a company must do to comply with a BAT is properly fill out its tax return based on its general books and records. Given the greater burdens of sales tax compliance as compared to BAT compliance, one could reasonably argue that it is appropriate to have a *higher* nexus threshold for a sales tax than for an income tax or other BAT.

- It could also be argued that the sales tax nexus threshold should be higher than the BAT threshold because in the case of the sales tax a business is being "drafted" to collect a tax that is actually owed by the purchaser and that the state would be capable of collecting directly from the purchaser (with sufficiently intrusive auditing). In contrast, a BAT is the legal liability of the business being asked to pay it; there is no other party from whom the tax could be collected. (One could not reasonably ask the in-state purchaser to estimate the *profit* earned on her purchase and send the tax due on it to the home-state tax agency rather than to the seller.) Thus, if states are to have the right to tax income earned within their borders by individuals and businesses alike (and no one proposes that they be stripped of this long-established right), and if businesses are capable of earning such income without being physically present (which they are), it is illogical for states to be barred from taxing that income merely because the business is not physically present within the state.

Claim:

BATSA is needed to stop states from asserting that they have the right to tax corporations that do no production within their borders but merely have customers there. Such a position is illegitimate because corporations earn income only where they produce goods and services, not where they sell them.

Rebuttal:

- The corporate income tax laws of virtually all states incorporate provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was promulgated in 1957 as a model state law for dividing corporate profits among the states for tax purposes. UDITPA was developed in a joint business-state task force, and it explicitly recognized making sales as an activity that contributes to the generation of business profit. Thus, in making the above claim, BATSA proponents are seeking to deny the existence of and reverse a 50-year-old consensus between the business community and state tax officials concerning where profits are earned.

- Much more recently, in the early 1990s, the Multistate Tax Commission (a joint agency of state tax departments), developed model rules aimed at clarifying where profits from such services as banking, publishing, and radio and TV broadcasting should be deemed to be earned. The traditional rules had assigned such income to the states in which the production of those services occurred. The new rules developed by the MTC assign that income to a much greater extent to the states in which the customers of those businesses are located. Several corporations playing a prominent role in lobbying for BATSA *supported* the adoption of the new MTC rules covering their industries.[1] Thus, the claim that "corporations only earn income where they produce, not where they sell" is completely inconsistent with the explicit position taken by many of the bill's proponents as recently as 15-20 years ago.

- Many corporations supporting BATSA have actively worked to enact legislation at the state level that is based on the premise that corporations earn profits *only* in the states in which they sell, and *not at all* in the states in which they produce (see: www.cbpp.org/1-26-05sfp.htm).

Claim:

Under international tax treaties that apply to *national* corporate income taxes, the nexus threshold for multinational corporations being taxable in another *country* is a "permanent establishment" (PE), that is, a brick-and-mortar facility. This is a further demonstration that the "physical presence" standard that BATSA would implement is an international norm for corporate income tax nexus.

Rebuttal:

- The PE threshold is part of a U.S. international tax structure that is completely different from the structure of state corporate income taxes and therefore is irrelevant to the nexus rules that should apply to multistate corporations. For example, since U.S.-based corporations are subject to tax on their worldwide incomes, PE rules affect only *where* a U.S. corporation's profits are taxed, not *if* they are taxed. In contrast, if a federal nexus law blocks a state in which a corporation has customers but no direct physical presence from taxing that corporation, a significant share of that corporation's profit is likely to be completely untaxed by any state. (See: www.cbpp.org/12-13-05tax.htm.)

- There are a significant number of policymakers who question the continued appropriateness of the PE standard for national-level corporate income taxes.[2] For example, a recent report of an Organization for Economic Cooperation and Development task force noted: "An enterprise now has the ability to electronically project a business presence to almost any corner of the globe and to deliver many products and services electronically. Enterprises no longer need to

establish branch offices, staffed with people who can provide local services or face-to-face contact, in each of its major markets. The need for a human presence (and supporting physical infrastructure) in diverse locations may be much reduced. *In these circumstances, these [task force] members questioned whether a taxing threshold built on physical presence of an enterprise remains appropriate.*" [Emphasis added.] The fact that the task force recommended no change in the PE rules was attributable to its inability to agree on an alternative likely to be widely adopted, not on a consensus that the PE rules themselves remain correct.[3]

Claims About the Need for Specific Provisions of the Bill

Claim:

BATSA contains reasonable "safe harbors" that allow a corporation to have a "de minimis" amount of physical presence in a state before establishing nexus. The provision of BATSA that allows a corporation to have employees or property in the state for up to 21 days in a tax year without creating nexus is such a reasonable "de minimis" threshold.

Rebuttal:

- The 21-day safe harbor is completely inconsistent with the underlying rationale for BATSA, which is that a corporation's tax obligations to a state should be balanced with the benefits it receives from public services provided by the state. For example, BATSA immunizes a corporation with 100 employees in a state for 20 days from all BATs, while a corporation with just one employee in the state for 22 days could be required by a state to pay the BAT. Clearly, the first corporation is benefiting more from police, fire, transportation, and other services provided to its employees than is the second corporation, and yet it is the first corporation that BATSA exempts from taxation.

- The other safe harbors in BATSA are just as illogical and inconsistent with the fundamental rationale offered for the bill. For example, having a million dollar's worth of property in a state that is being processed by another business does not create nexus under BATSA, but storing a million dollars worth of finished inventory in the state does. There is no reason to believe that the value of police and fire protection being provided to both types of property is any different, yet one type of property creates nexus under BATSA and the other doesn't.

Claim:

Public Law 86-272 was enacted by Congress in 1959 and decrees that a state may not impose a corporate income tax on an out-of-state business whose only activity within the state is soliciting sales of tangible goods (including through the use of a traveling salesforce), if the orders are fulfilled from an out-of-state shipment point. BATSA is needed to "modernize" P.L. 86-272 by extending it to all BATs and to sales of services in addition to sales of goods.

Rebuttal:

- P.L. 86-272 was intended to be a temporary measure to hold a 1959 Supreme Court decision in abeyance. That decision signaled the end of a now completely discarded Supreme Court

doctrine holding that states couldn't tax interstate commerce at all. P.L. 86-272 is an obsolete nexus law that violates the core rationale offered for BATSA — that only physically-present businesses should be subject to a BAT because only such businesses benefit from public services. P.L. 86-272 violates this principle because it allows a corporation to have an unlimited number of salespeople in a state and an unlimited amount of goods en route to customers in an unlimited number of company-owned trucks and yet still not create corporate income tax nexus. P.L. 86-272 should be repealed, not broadened, even under a true "physical presence" nexus standard. Its extension to sales of services and other BATs would be the opposite of "modernization."

- Extending P.L. 86-272 to the sale of services would be problematic and likely to spawn considerable litigation. In the case of a sale of goods, it is possible to draw the line between in-state solicitation of an order and fulfillment of the order from an out-of-state origination point with reasonable objectivity. That will not be true with the sale of services in many instances. For example, if a credit card holder uses her card to borrow cash from an out-of-state bank at an in-state ATM machine, is the service "fulfilled" in-state where the cash is delivered (which the state is likely to assert) or out-of-state at the credit card company's computer server that electronically "authorizes" the loan (which the bank is likely to assert)? Costly litigation will have to resolve many such questions if BATSA extends P.L. 86-272 to sellers of services.

Claim:

Many states take the position that if a corporation engages in solicitation or other market-enhancing activity within its borders on behalf of an out-of-state corporation, that creates nexus for the out-of-state corporation. BATSA is needed to stop states from aggressively and unfairly seeking to "attribute" nexus from one corporation to another in this manner. "Attributional nexus" is unfair and unreasonable because the state can tax the income of the in-state corporation and shouldn't be allowed to tax the income of the out-of-state corporation as well. Therefore, BATSA appropriately provides that the "market-creating" and "market-maintaining" activities of an in-state agent never establish nexus for the out-of-state company on whose behalf the agent is working if the agent represents at least two different clients.

Rebuttal:

- The U.S. Supreme Court upheld the fairness of "attributional nexus" for BATs in a decision issued nearly 20 years ago. In an even earlier sales tax nexus case, the Court observed that allowing a corporation to avoid nexus in a state by having "independent contractors" act on its behalf rather than using its own employees "would open the gates to a stampede of tax avoidance."

- The provision of BATSA blocking "attributional nexus" that is being defended here seeks to undermine the fundamental and longstanding operation of state corporate income taxes. Such taxes do not seek to divide marketing activities conducted in one state from production activities conducted in another. Rather, once a manufacturer (for example) establishes nexus in a state, that state taxes an apportioned share of the nationwide activities of the business, from the purchase of raw materials up to and including the final sale of the product to the ultimate customer. Under such a system, it makes no sense to bar a state from being able to tax a share of the profit earned from the manufacturing activities merely because the in-state marketing

activities were conducted by a third party rather than the manufacturer's own employees. Even worse, under BATSA the "market-creating" activities could be conducted by a wholly-owned and controlled subsidiary of the manufacturer and not create nexus for the latter, if the goods were produced by two nominally separate subsidiary corporations. (See: www.cbpp.org/9-14-04sfp-append.pdf, pp. 7 - 11.)

Claims About Alleged Harms that the Enactment of BATSA Will Stop

Claim:

By establishing a clear, nationally-applicable, physical-presence nexus standard, BATSA will substantially reduce the amount of nexus-related litigation that is occurring.

Rebuttal:

- BATSA contains numerous undefined terms that will generate considerable litigation, just as P.L. 86-272 has generated — and continues to generate — substantial litigation. For example, BATSA includes a provision declaring that nexus is not created by the ownership of in-state property "used to furnish a service to the owner. . . by another person," with no explanation of what might be encompassed in such a broad statement. Because Congress failed to define the key "safe harbor" provision in P.L. 86-272 — "solicitation" — constant litigation occurred for more than 30 years until the U.S. Supreme Court accepted a case that offered some (minimal) guidance. BATSA will generate even more litigation than P.L. 86-272 did, because it is a much more comprehensive and complex bill.

- A recent law review article documented 57 reported cases interpreting P.L. 86-272; BATSA proponents cite only about a dozen BAT nexus cases that do not involve P.L. 86-272. Thus, the claim of BATSA proponents that "Public Law 86-272 has generated relatively few cases, perhaps a score or two . . . [while] areas outside its coverage have been litigated extensively" is untrue.

- As documented in another Center report (see: www.cbpp.org/9-14-04sfp.htm), BATSA will open up enormous opportunities for corporations to shelter their profits from taxation in many of the states in which they are earned. As a result, states will have no alternative but to use every legal means at their disposal to protect their tax bases. BATSA therefore will not reduce litigation between states and taxpayers, but — at best — merely displace it from nexus cases to cases challenging the use of these "fallback" approaches. For example, many states have discretionary authority to treat in-state and out-of-state subsidiaries for tax purposes as if they are one corporation but rarely use it because its exercise is almost always challenged in court. Because of the damage that will be done by BATSA to their revenues, states are more likely to use this authority, with additional litigation resulting.

- The enactment of BATSA will not bring nationwide uniformity to nexus law. BATSA's provisions will be interpreted by state courts and, just as occurred under P.L. 86-272, state courts will reach different conclusions about what the provisions mean. Only a U.S. Supreme Court decision interpreting BATSA can provide a measure of national nexus law uniformity, and in the nearly 50 year history of P.L. 86-272, the Court has accepted a single appeal from a state P.L. 86-272 case of general applicability.

Claim:

The aggressive efforts of state tax administrators to assert nexus over corporations that merely have customers within their borders are creating enormous uncertainty for these businesses about their BAT payment obligations. This uncertainty is "chilling. . . interstate economic activity," encouraging U.S. corporations to invest abroad rather than here, and discouraging foreign corporations from investing in the United States.

Rebuttal:

- BATSA proponents substantially exaggerate both the nexus enforcement efforts of state tax officials and the uncertainty surrounding the state of BAT nexus law. There is no uncertainty about the nexus rules that apply to businesses that conduct the vast majority of transactions in the U.S. economy. P.L. 86-272 governs the application of state corporate income taxes to all sales of goods, and state tax officials can't get around it no matter how "aggressive" they might like to be in theory. Where P.L. 86-272 doesn't apply, there is little ambiguity in practice, because the majority of transactions are made with some in-state physical presence of the selling corporation (which clearly creates nexus). The vast majority of court cases and enforcement actions that have been initiated by states to compel income tax payments by allegedly non-physically-present corporations have been aimed at nullifying a single, abusive tax shelter that, in fact, relies on the physical presence within the state of the out-of-state corporation's trademark.

- In all the years that BATSA has been under consideration in Congress, and with all the millions of businesses operating in the United States, BATSA proponents have managed to come up with a single, concrete example of a company that allegedly has decided not to make cross-border sales into a (single) state because of the state's assertion of nexus over it despite its lack of physical presence within the state.[4] The isolated small service business aside, it is highly implausible that large, national businesses are constraining their own growth by deciding not to do business in particular states because of BAT nexus issues. Where are the examples of national fast-food chains that refuse to license franchisees in particular states because of fears of aggressive assertion of nexus over the franchisor? Where are the examples of national banks that won't issue credit cards to residents of particular states because of nexus concerns? Until such examples are provided and documented, claims that interstate commerce — and therefore job growth— is being significantly stifled by concerns about creating BAT nexus in additional states should not be given any credence.

- If anything, the enactment of BATSA is likely to harm the economy by providing a disincentive for optimal business location decisions. As the Director of the Oregon Department of Revenue has argued:

  > [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in

> additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.

BATSA proponents argue that the bill is needed to prevent "aggressive" state assertion of nexus from stifling interstate commerce, which they suggest is synonymous with interstate *sales.* They completely fail to acknowledge that interstate commerce also encompasses interstate *investment and job creation*, and that BATSA has the potential to discourage this by creating an artificial, tax-based incentive for corporations to tap into the consumer market in a state without placing facilities and jobs within the state's borders.

- This same logic undermines the (unsubstantiated) claims that nexus uncertainty is encouraging U.S. businesses to produce abroad and discouraging foreign direct investment in the United States. If anything, it is much more likely that the enactment of BATSA would have these effects. BATSA would allow both foreign subsidiaries of U.S.-based corporations and foreign-based corporations to conduct more activities in the United States to "establish and maintain" their markets here without creating BAT nexus. This could encourage them to fulfill U.S. demand for their goods and services through export from foreign factories and other facilities rather than produce those goods and services here with American workers. Moreover, the data on foreign direct investment do not substantiate the claim that BAT nexus "uncertainty" is putting a "real damper" on foreign direct investment here. While such investment fluctuates enormously from year to year and is well below the peak years of 1998-2001, it rose from 2002 to 2004. In 2004, foreign direct investment in the United States remained well above the level of the early 1990s, when a few states began to enforce the allegedly aggressive, "economic presence" approach to defining nexus.

Claim:

If the state nexus threshold for the imposition of a BAT is not raised at least as high as the provisions of BATSA, the U.S. economy and U.S. corporations are at substantial risk of retaliation from foreign governments that are angry that corporations headquartered in their nations can have income tax nexus in a state without having a "permanent establishment" in the United States. Foreign governments might also seek to renegotiate their tax treaties with the United States to eliminate the PE threshold. This would free them to impose their national-level corporate income taxes on non-physically-present U.S. corporations, just as states are imposing their income taxes on non-physically-present foreign corporations. Thus, "[e]nactment of [BATSA], which includes a nexus standard that is analogous to those found in U.S. tax treaties, is essential for ensuring that the current international system of taxation remains intact."

Rebuttal:

- BATSA proponents have presented no evidence to back up their claim that the United States is at risk of economic harm due to retaliation from foreign governments angered by state nexus standards that differ from "permanent establishment" rules. To the contrary, a report issued periodically by the European Union details U.S. federal and state policies that the EU views as trade barriers but makes no mention of state nexus standards — even as it does object to other state tax practices.[5]

- State nexus thresholds have been far lower than the PE standard for decades. There is no evidence that foreign governments have ever actively sought to renegotiate the tax treaties to eliminate the PE rules so that they could apply their national-level taxes to non-physically-present corporations in retaliation for state nexus thresholds that are lower than the PE rules. In any case, the federal government would be under no compulsion to accept a demand from foreign treaty partners that the PE standard be eliminated.

Notes

[1] See a letter dated November 11, 1995 from Fred E. Ferguson of Arthur Andersen representing the Financial Institutions State Tax Coalition to the Chairman of the Multistate Tax Commission in support of the proposed financial institutions apportionment regulation. The letter states: "The FIST Coalition believes that the Apportionment Rules should serve as the model for uniform state apportionment of income of financial institutions. We encourage the MTC to adopt the rules, recommend that its member states favorably consider the rules for adoption, and urge the MTC to seek uniform adoption among non-member states as well." The rules being endorsed included provisions assigning receipts from interest to the states in which a bank's borrowers are located. Members of the FIST Coalition named in the letter include Citicorp/Citibank and Bank of America, both of which now support BATSA. See also a letter dated April 16, 1990 from Ruurd Leegstra of Price Waterhouse to the MTC's General Counsel accompanying a "Proposal of the Broadcasters" dated April 13, 1990 and drafted by the ABC and NBC networks. The proposal included a provision apportioning advertising receipts of radio and television broadcasters based on the location of listeners/viewers. Both letters are on file in the headquarters office of the MTC.

[2] See: OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?* Final Report, 2006. For example, see paragraphs 43, 44, 51, and 120.

[3] See the source cited in the previous note. "For the [task force], fundamental changes should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that have been suggested so far appears to meet that condition. The need to refrain from fundamental changes unless clearly superior alternatives are found is especially important since any attempt to change the fundamental aspects of the current international rules for taxing business profits would create difficult transition rules given the fact that many countries would likely disagree with such changes and that a long period of time would be required for the gradual adaptation of the existing network of tax treaties."

[4] See the testimony of Carey J. Horne on pp. 9-13 of the September 27, 2005 hearing on H.R. 1956 before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee.

[5] See: European Commission, "United States Barriers to Trade and Investment, Report for 2005," March 2006, pp. 65-67.

STATEMENT OF THE
COALITION FOR RATIONAL AND FAIR TAXATION*
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL TRADE
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
STATE JURISDICTION TO TAX BUSINESS ACTIVITY
JULY 25, 2006

The Coalition for Rational and Fair Taxation ("CRAFT"), is a diverse coalition of some of America's largest corporations involved in interstate commerce, including technology companies, broadcasters, interstate direct retailers, publishers, financial services businesses, traditional manufacturers, and multistate entertainment and service businesses. The businesses maintain locations throughout the United States and employ several hundred thousand employees in our country.

This statement focuses on why a bright-line, quantifiable physical presence nexus standard, as is provided in S. 2721, is the appropriate standard for state and local taxation of out-of-state businesses and why modernization of Public Law 86-272, as S. 2721 would accomplish, is essential to the U.S. economy. CRAFT strongly supports S. 2721 and respectfully urges your approval of this legislation for consideration by the full Congress and ultimate enactment. We believe that it is essential for Congress to act to provide clear guidance to the states in the area of state taxing jurisdiction, remove the drag that the current climate of uncertainty places on American businesses, and thereby protect American jobs and enhance the U.S. economy.

Overview

The principal motivation for the adoption of the United States Constitution as a replacement to the Articles of Confederation was a desire to establish and ensure the maintenance of a single, integrated, robust American economy. This is reflected in the Commerce Clause, which provides Congress with the authority to safeguard the free flow of interstate commerce. As an additional consideration, the Supreme Court has determined, in the context of the Due Process Clause, that, in the area of state taxation, "the simple but controlling question is whether the state has given anything for which it can ask return."[1]

* c/o Arthur R. Rosen, Counsel
McDermott Will & Emery LLP
340 Madison Avenue
New York, NY 10017

[1] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).

Unfortunately, some state revenue departments have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on businesses located in other states that have little or no connection to their state. Some state revenue departments have even asserted that they can tax a business that merely has customers in the state based on the recently-minted notion of "economic nexus." Such behavior is entirely logical on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state's society. But this country has long stood against such taxation without representation. And worse, the "economic nexus" concept flies in the face of the current state of business activity taxation, which is largely based on the notion that a business should only be subject to tax by a state from which the business receives benefits and protections. And worse still, it creates significant uncertainty that has a chilling effect on interstate economic activity, dampening business expansion and job growth. Practicing tax attorneys and accountants regularly advise businesses that ultimately decide not to engage in a particular transaction in another state out of concern that those businesses might become subject to tax liability in that state. It is entirely appropriate for Congress to intervene to prevent individual states from erecting such barriers to trade, and to protect and promote the free flow of commerce between the states for the benefit of the U.S. economy.[2]

Consistent with principles enumerated by the majority of the federal Advisory Commission on Electronic Commerce ("ACEC"),[3] and earlier by the Congressional Willis Commission in 1965, the Business Activity Tax Simplification Act is designed to address the issue of when a state should have authority to impose a direct tax on a business that has no or merely a minimal connection with the state. This issue has become increasingly pressing as the U.S. and global economies have become less goods-focused and more service-oriented and as the use of modern technology has proliferated throughout the country and the world. S. 2721 applies to state and local business activity taxes, which are direct taxes such as corporate income taxes, gross receipts taxes, franchise taxes, gross profits taxes, and capital stock taxes that are imposed on businesses engaged in interstate commerce. S. 2721 does not apply to other taxes, like personal income taxes,[4] gross premium taxes imposed on insurance companies, or transaction taxes measured by gross receipts, such as the New Mexico Gross Receipts and Compensating Tax Act.[5]

The underlying principle of this legislation is that states and localities that provide benefits and protections to a business, like education, roads, fire and police protection, water, sewer, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, S. 2721 ensures that state tax impositions are appropriately borne only

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[2] *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).
[3] *See* Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965); and Advisory Commission on Electronic Commerce, "Report to Congress," pp. 17-20 (April 2000), respectively.
[4] In addition, nothing in S. 2721 affects the responsibilities of an employer to withhold personal income taxes paid to resident and nonresident employees earning income in a state or to pay employment or unemployment taxes.
[5] N.M. STAT. § 7-9-1 *et seq.*

by those businesses that receive such benefits and protection from the taxing state. S. 2721 does so in a manner that ensures that the business community continues to pay its fair share of tax but that puts a stop to new and unfair tax impositions. Perhaps most important, S. 2721's physical presence nexus standard is entirely consistent with the jurisdictional standard that the federal government uses in tax treaties with its trading partners. In fact, creating consistency with the international standards of business taxation is vital to eliminating uncertainty and promoting the growth of the U.S. economy.

Background

The question of when a state has the authority to impose a tax directly on a business domiciled outside the state has been asked for decades.[6] In 1959, the Supreme Court ruled that a corporation with several sales people assigned to an office located in the State of Minnesota could be subjected to that state's direct tax scheme.[7] Prior to that time, there had been a "well-settled rule, stated in *Norton Co. v. Illinois Dept. of Revenue*, 340 U.S. 534 (1951), that solicitation in interstate commerce was protected from taxation in the State where the solicitation took place."[8] The Supreme Court's 1959 decision in *Northwestern States Portland Cement*, coupled with the Court's refusal to hear two other cases[9] (where the taxpayers, which did not maintain offices in the state, conducted activities in the state that were limited to mere solicitation of orders by visiting salespeople), cast some doubt on that "well-settled rule" and fueled significant concern within the business community that the states could tax out-of-state businesses with unfettered authority, thereby imposing significant costs on businesses and harm to the U.S. economy in general. As a result, Congress responded rapidly, enacting Public Law 86-272 a mere six months later. Public Law 86-272 prohibits states and localities from imposing income taxes on a business whose activities within the state are limited to soliciting sales of tangible personal property, if those orders are accepted outside the state and the goods are shipped or delivered into the state from outside the state.[10] Subsequently, the Congressional Willis Commission studied this and other interstate tax issues and concluded that, among other things, a business should not be subject to a direct tax imposition by a state in which it merely had customers.[11]

The bottom line is that businesses should pay tax where they *earn* income. It may be true, as certain state tax collectors assert, that without sales there can be no income. While this may make for a nice sound bite, it simply is not relevant. Income is earned where an individual or business entity employs its labor and capital, *i.e.*, where he, she, or it actually performs work.[12] In fact, as early as 1919, the Attorney General of the State of New York pointed out that

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[6] *See, e.g.*, Walter Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 Tax Law. 37 (1987).
[7] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).
[8] *Wisconsin Dep't of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 238 (1992) (Kennedy, J., dissenting).
[9] *Brown Forman Distillers Corp. v. Collector of Revenue*, 101 So.2d 70 (La. 1958), *appeal dismissed and cert. denied*, 359 U.S. 28 (1959); *International Shoe Co. v. Fontenot*, 107 So.2d 640 (La. 1958), *cert. denied*, 359 U.S. 984 (1959).
[10] P.L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381 *et seq.*).
[11] Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary of the U.S. House of Representatives, "State Taxation of Interstate Commerce," H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965), Vol. 1, Part VI., ch. 39, 42. *See also* W. Val Oveson, *Lessons in State Tax Simplification*, 2002 State Tax Today 18-39 (Jan. 20, 2002).
[12] As noted by one state tax expert, "'[i]ncome,' we were told long ago, 'may be defined as the gain derived from

"the work done, *rather than the person paying for it*, should be regarded as the 'source' of income."[13]

The Business Activity Tax Simplification Act provides simple and identifiable standards that will significantly minimize litigation by establishing clear rules for *all* states, thereby freeing scarce resources for more productive uses both in and out of government. Although it is unlikely that S. 2721 will end all controversies, any statute that adds nationwide clarification obviously reduces the amount of controversy and litigation by narrowing the areas of dispute. For example, in the 47 years since its enactment in 1959, Public Law 86-272 has generated relatively few cases, perhaps a score or two. On the other hand, areas outside its coverage have been litigated extensively and at great expense. Recent litigation has focused on what the appropriate nexus standard for business activity taxes actually is; there is no indication that this issue will be settled absent Congressional action.

S. 2721's Provisions

Codification of the Physical Presence Standard. S. 2721 provides that, pursuant to Congress' Commerce Clause authority, a state or locality may not impose business activity taxes on businesses that do not have a "physical presence" within the jurisdiction. The requisite degree of physical presence (employees, property, or the use of third parties to perform certain activities) is set at greater than 21 days during a taxable year, with certain specified incidences of presence being disregarded as qualitatively *de minimis*.

The 21-day quantitative *de minimis* threshold is measured by each day that a business assigns one or more employees in the state, uses the services of certain third parties in the state, or has certain property in the state. Taxpayer compliance and state revenue department administration of this standard would thus be quite simple and straightforward.

There are two exceptions to the 21-day rule that apply to those who really do earn their income during shorter visits to the state. Both exceptions are consistent with the underlying intent of S. 2721 that businesses pay tax where income is actually earned.

For a qualitative *de minimis* standard, S. 2721 provides that certain property or certain activities engaged in by a business' employees within the jurisdiction's boundaries will not be considered in determining whether a business has the requisite physical presence in the jurisdiction. This approach of disregarding certain activities for nexus purposes has already been recognized in Public Law 86-272, where Congress determined that mere solicitation is qualitatively *de minimis* relative to the benefits that protecting such activities offers to the U.S. economy. The protected activities are limited to situations where the business is *patronizing* the local market (*i.e.*, being a customer), and thereby generating economic activity in the state that produces other tax revenues for the state, rather than *exploiting* that market (many states have issued rulings, albeit inconsistent and *ad hoc* in nature, recognizing this principle), including ancillary property and activities.

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capital, from labor, or from both combined.'" W. Hellerstein, *On the Proposed Single-Factor Formula in Michigan*, State Tax Notes, Oct. 2, 1995, at 1000 (quoting *Eisner v. Macomber*, 252 U.S. 189, 207 (1920)).

[13] Op. N.Y. Att'y Gen. 301 (May 29, 1919) (emphasis added).

In the area of attributing one business' physical presence in a state to another, S. 2721 provides that an out-of-state business will have a physical presence in a state if that business uses the services of an in-state person, on more than 21 days, to perform services that establish or maintain the nonresident business' market in that state, unless the in-state person performs similar functions for more than one business during the year. The ownership relationship between the out-of-state person and the in-state person is irrelevant for purposes of this provision. By limiting attribution of nexus only to situations involving market enhancing activities, S. 2721 not only more accurately reflects the economics of a transaction or business, but is also consistent with the current state of the law. Expanding attribution any further would undermine the principles of fairness and equity in taxation. To the extent that a separate company is conducting business in a state, its own income, including appropriate entrepreneurial profit, is subject to tax in that state. In other words, limiting attribution ensures that a state taxes the economic activity that actually occurs in that state but not the activity that occurs elsewhere.

As an example, suppose a manufacturing company located only in State A uses a sales company in State B to market and sell the manufacturer's product in State B. The sales company is conducting a business activity within State B and there is no doubt that it should be subject to tax by the state. That state will receive tax revenues commensurate with the marketing and selling activities that actually occur in the state; the tax revenues will be based on the compensation, set at fair market value, that the manufacturer pays the sales company for its marketing and selling services (*i.e.*, the in-state activities that add value in the economic stream). As for the manufacturing company, its activities constitute a separate business activity that takes place totally outside of State B. Putting this example in a global context, attempts by the state of manufacture to tax the out-of-state manufacturing company would be akin to France attempting to impose tax on the manufacturing income of every American business that contracts with a French marketing company to market and sell products in France. Clearly, it is simply too attenuated to argue that using the services of the in-state marketing company subjects the out-of-state manufacturer to tax on the manufacturing activity as well.

Modernization of Public Law 86-272. As noted earlier, our economy has undergone significant changes in the 47 years since Public Law 86-272 was enacted. In addition to codifying the physical presence nexus standard, the Business Activity Tax Simplification Act extends the longstanding protections of Public Law 86-272 to *all* sales, not just to sales of tangible personal property, in recognition of those changes, specifically, the change in the focus of the American economy from goods to services and the increased importance of intangible property in the marketplace.

The Business Activity Tax Simplification Act also modernizes Public Law 86-272 by addressing the efforts of some aggressive states to avoid the restrictions imposed by Congress in Public Law 86-272 by establishing taxes on business activity that are measured by means other than the net income of the business. Two examples of these new state business activity taxes are the Michigan Single Business Tax, which imposes a tax on a company's business activities in the state, not on net income, and the New Jersey Corporation Business Tax, which was amended effective in 2002 to impose a gross profits/gross receipts tax. What is most distressing about the New Jersey amendments is that, as of July 1, 2006, these "gross" taxes apply *only* to businesses protected by Public Law 86-272. In other words, New Jersey has effectively circumvented the Congressional policy decision underlying the enactment of Public Law 86-272 by imposing a

non-income tax only on those businesses that would otherwise be protected by the Public Law. States are increasingly turning to non-income based business activity taxes, in large part to avoid the effect of federal law. Both Ohio and Texas have recently done just that. S. 2721 addresses this by ensuring that Public Law 86-272 covers *all* business activity taxes, not just net income taxes.

Federalism

S. 2721 strikes the correct balance between state autonomy/sovereignty and the regulation of interstate commerce.[14] S. 2721 merely codifies current jurisdictional standards for *when* a business may impose a tax; the bill does nothing to determine *how* a state may tax businesses that are properly subject to its taxing jurisdiction. A state remains free to determine what type of tax to impose, be it an income tax, a gross receipts tax, a value added tax, or a capital stock tax; to determine how to apportion the income that is taxed in the state, be it a single- or three-factor formula based on property, payroll and/or sales; to set the rate at which the tax chosen will be imposed; to determine whether or not to follow federal taxable income, *e.g.*, to choose whether to decouple from federal bonus depreciation; to provide credits or deductions for certain types of expenses; and so on.

On the other hand, the economic nexus standard (*i.e.*, establishing the requisite nexus based solely on a business having a customer in the taxing jurisdiction) asserts that a business is liable for a business activity tax if that business has derived revenue or income from a customer in a state – even though the business has conducted no activities in the state (*i.e.*, has had no property or employees located in that state). Keeping in mind that every buyer in a transaction in a free market economy benefits from the transaction as much as the seller, the economic nexus standard effectively imposes a toll charge on out-of-state businesses for exchanging cash for property (or for the provision of a service). Such a tax acts as a tariff on interstate commerce and creates exactly the problem that existed under the Articles of Confederation and that led to the adoption of the Constitution. Under the Articles of Confederation, state taxes and duties impeded interstate commerce as states began enacting their own tariffs and taxing interstate commerce, thereby putting up trade barriers to free trade.[15] This led to some states retaliating by banning products from other states. By effectively imposing such toll charges, the economic nexus standard would clearly have a negative impact on interstate commerce.

Comparison to Current Common Law

The physical presence nexus standard in S. 2721 is consistent with the current state of the law. An out-of-state business must have nexus under *both* the Constitution's Due Process Clause and its Commerce Clause before a state has the authority to impose tax on that business. The Supreme Court has determined that the Commerce Clause requires the existence of a "substantial nexus" between the taxing state and a putative taxpayer for all state taxes, whereas the Due Process Clause requires only a "minimum" connection. In *Quill*, the Supreme Court determined, in the context of a business collecting sales and use taxes from its customers, that the substantial nexus requirement could be satisfied only by the taxpayer having a physical presence in the state;

[14] For a detailed list of instances where Congress has exercised its authority under the Commerce Clause, *see* Frank Shafroth, *The Road Since Philadelphia*, 30 State Tax Notes 155 (October 13, 2003).
[15] *See, e.g.*, *Gibbons v. Ogden*, 22 U.S. (9 Wheat.) 1, 11 (1824); *Quill v. North Dakota*, 504 U.S. 298, 313 (1992).

the Court refrained from articulating the appropriate measure for business activity taxes.[16] This is because under the American legal system, a court only has the authority and responsibility to address the case before it. The Supreme Court has not granted a writ of *certiorari* for a case that would permit it to address the business activity tax nexus issue. So what constitutes substantial nexus for business activity taxes?[17]

Since the Court has not yet ruled on this issue, we must use clear logic and review what state courts and tribunals have recently decided. The answer is clear: if non-*de minimis* physical presence is the test for a mere collection and remission situation such as is the case for sales and use taxes, physical presence must be, at a bare minimum, the appropriate test for the imposition of business activity taxes. Indeed, the standard for business activity taxes should, if anything, be *higher* than the standard for sales taxes for at least two reasons. First, a business activity tax is an actual direct tax (and not a mere obligation to collect tax from someone else) and the consequent greater economic burden should require a greater connection (as the Supreme Court seems to have recognized in *National Geographic Society v. Board of Equalization*).[18] Second, the risk of multiple taxation is higher for income taxes than for sales and use taxes. Sales and use taxes typically involve only two jurisdictions (the state of origin and the state of destination). However, corporate business activities often create contacts with many states. Most of the state-level decisions on this issue have concluded that there is no principled reason for there to be any lower standard for business activity taxes than for sales and use taxes.[19] Finally, the complexities, intricacies, and inconsistencies among business activity taxes easily overshadow the administrative difficulties related to sales and use tax.

Effect on State Revenues

There simply is no basis for any contention that S. 2721 could lead to any significant loss of state revenues. The most recent study, performed on a state-by-state, industry-by-industry, bill section-by-bill section basis, shows that the likely effect of S. 2721 is less than 0.1% of state and local taxes currently paid by businesses. It is essential to keep in mind that S. 2721 is based on the principle that a business engaged in interstate commerce should pay its fair share of tax.[20]

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

[17] Opponents of a physical presence standard cite *International Harvester*, a 1944 United States Supreme Court case, as support for their position that economic nexus is appropriate. *See International Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944). Reliance on this case is simply not appropriate because to do so ignores a full 60 years of subsequent jurisprudence (*e.g., Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977) and *Quill*). But even more fundamentally, the case involved a Due Process analysis and never considered the requirements of the Commerce Clause. In addition, when read in the proper context, it is clear that *International Harvester* does not endorse an economic presence standard for business activity taxes. In fact, *International Harvester* concerned the ability of Wisconsin to require a corporation with a physical presence in the state to withhold tax on dividends that it paid to its shareholders. Further, the imposition of liability on the corporation can be seen as merely a delayed income tax on the physically present corporation. Clearly, this case is not to be relied upon to determine the appropriate nexus standard for business activity taxes.

[18] *National Geographic Society v. Board of Equalization*, 430 U.S. 551 (1977).

[19] This includes *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000); *America Online v. Johnson*, No. 97-3786-III, Tenn. Chancery Ct. (Mar. 13, 2001); *Cerro Copper Prods., Inc.*, No. F-94-444, 1995 Ala. Tax LEXIS 211 (Ala. Dep't of Revenue Dec. 11, 1995), *reh'g denied*, 1996 Ala. Tax LEXIS 17 (Ala Dep't of Revenue Jan. 29, 1996) (*But see Lanzi v. State of Alabama Department of Revenue*, Ala. Dep't of Rev., Admin. L. Div., No. INC. 02-721 (Sept. 26, 2003)).

[20] A recent study commissioned by the Council on State Taxation found that businesses (not including pass-through

S. 2721 does not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the correct jurisdiction.

S. 2721 does not depart to any significant degree from what is now being done in the states. The operational reason for this has been confirmed by the former executive director of the Multistate Tax Commission.[21] Outside the context of passive investment companies,[22] state revenue departments simply have not been successful in their attempts to assert economic nexus to impose tax on businesses that do not have a physical presence in the state.

S. 2721 would have no effect on taxes derived from businesses that maintain a facility in the jurisdiction for more than 21 days during the taxable year. Clearly, state and local governments derive most – if not virtually all – of their business activity tax revenue from such businesses. The amount of revenue received by taxing jurisdictions from those businesses that maintain no office, store, warehouse, or other facility – or even inventory – in the jurisdiction at all must truly be minimal.

It simply cannot be the case that S. 2721 would have more than a negligible revenue impact to the states. Charges by critics that the bill would have a significant fiscal effect are simply masking what is really going on, *i.e.*, that state revenue departments and their representatives do not want any legislative constraints on or oversight of their taxing authority – even when the legislative constraints are squarely within Congress' authority to regulate interstate commerce.[23]

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entities) paid $378.9 billion in state and local taxes in 2002, an amount that was considered to be at least business' fair share of tax. *See* Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, *A Closer Examination of the Total State and Local Business Tax Burden*, 27 State Tax Notes 295 (Jan. 27, 2003).

[21] "It seems to me that the states need to face the reality that most of them are generally incapable of enforcing the 'doing business' standard anyway; in almost all cases they really fall back on the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses for income tax jurisdiction purposes, they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general – and with mixed success, at best. In short, it may be that the states would be forgoing the collection of corporate income taxes that they do not and cannot collect anyway." Eugene Corrigan, *States Should Consider Trade-Off on Remote-Sales Problem* (letter to the editor), 27 State Tax Notes 523 (Feb. 10, 2003).

[22] It is interesting to note that the states have now moved on to using other, more effective attacks against passive investment companies, such as the economic substance and *alter ego* arguments, combined reporting, and the denial of the relevant deductions. *See* Mitchell J. Tropin, *States Moving Away From 'Geoffrey,' Using Sham Arguments, 'Attribution' Nexus*, Daily Tax Report, No. 27 (Feb. 10, 2003).

[23] It is interesting that critics of proposals that address multistate taxation always counter with claims that the proposal will cause significant revenue loss to the states. *See, e.g., Corporate Tax Sheltering and The Impact On State Corporate Income Tax Revenue Collections,* Multistate Tax Commission (July 25, 2003); Dan Bucks, Elliott Dubin and Ken Beier, *Revenue Impact on State and Local Governments of Permanent Extension of the Internet Tax Freedom Act*, Multistate Tax Commission (Sept. 24, 2003); Michael Mazerov, *Making the Internet Tax Freedom Act Permanent in the Form Currently Proposed Would Lead to a Substantial Revenue Loss for States and Localities*, Center on Budget and Policy Priorities (October 20, 2003). Yet there is no reliable empirical evidence that states have actually lost revenue when measures affecting state taxation have been enacted. This certainly goes to the credibility (or lack thereof) of such claims. As an example of the unreliability of such claims, the National Conference of State Legislatures has expressed its concern over projections by some national organizations that the inclusion of telecommunications services in the Internet tax moratorium would cost the states $22 billion each year (an estimate representing the total revenue from all state and local telecommunication taxes in the 50 states from 1992); in a letter to Senator Alexander dated November 5, 2003, the Congressional Budget Office estimated that the actual revenue cost would be between $80 million and $120 million per year starting in 2007 – an estimate that is

Moreover, the statements of revenue impact made by certain state revenue departments and their representatives have been shown to be highly unreliable because the "estimates" focus on *potential* effects from *hypothetical* restructurings by businesses, are based on *hypothetical* changes in state law, or cite to *potential* impacts on apportionment rules (which is an issue of how much to tax, not whether to tax). Such considerations do not make for a reliable or accurate revenue estimate; proper revenue estimates are based on revenues currently collected. In reality, there simply will be no material effect on the amount of revenue received by the states because S. 2721 seeks to maintain the status quo.

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 sufficient reason to establish a physical presence nexus standard. The United States and its tax treaty partners have, for decades, adopted and implemented a "permanent establishment" rule. The "permanent establishment" concept is a long-standing principle and has been extremely important to U.S. businesses and, thus, to the U.S. economy.

A physical presence standard places an appropriate limit on states gaining taxation powers over out-of-state firms and conforms to common sense notions of fair play. It is significant that the OECD has recently studied the issue and preliminarily concluded that the "permanent establishment" rule should remain the proper standard for international tax treaties even with the proliferation of electronic commerce.[24]

Unfortunately, it has been said that some countries, citing the efforts of U.S. state revenue departments to impose direct taxes on any business that has customers within the state's borders, are now saying that they want to renegotiate their treaties with the United States so they can begin taxing every U.S. business that has a customer in their country. This would be a disaster for the U.S. economy. S. 2721 includes a nexus standard that is analogous to those found in U.S. tax treaties and so it is essential for ensuring that the current international system of taxation remains intact.

Effect on American Job Retention and Growth

The current level of uncertainty and ambiguity in the application of state-level taxes on U.S.-based businesses impedes new job creation. Rather than a clear set of federal rules regarding when a business is subject to state taxes, the current environment is governed largely by the level of aggressiveness of state tax administrators and ongoing litigation. As noted earlier, state tax officials have increasingly pushed the envelope in an effort to raise revenues from out-of-state enterprises. The uncertainty will only increase as states continue to assert jurisdiction over out-of-state businesses based on "economic nexus" principles.

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approximately 220 times smaller. *Accord* Congressional Budget Office Cost Estimate, H.R. 49, Internet Tax Nondiscrimination Act, as requested by the House Comm. on the Judiciary (July 21, 2003). In a November 4, 2003 action alert regarding S. 150, "The Internet Tax Non-Discrimination Act," the NCSL stated that "[t]he $20 billion estimation runs counter to expressed congressional intent and the provisions of the Manager's amendment and as a result threatens to seriously harm the credibility of state governments before Congress and the Administration."

[24] *See Are The Current Treaty Rules For Taxing Business Profits Appropriate For E-Commerce?,* Organisation for Economic Co-operation and Development, Technical Advisory Group on Monitoring the Application of Existing Treaty Norms For Taxing Business Profits, Public Discussion Draft (Nov. 26, 2003).

It is noteworthy that this uncertainty is borne chiefly by businesses based in the United States. Investing in the creation of new plants, equipment, and jobs in other countries is actually encouraged by the ambiguity in nexus standards and the aggressiveness of state tax officials. When combined with the effect of bilateral tax treaties and the difficulty of collecting state-level taxes from foreign enterprises, the uncertainty and ambiguity of state taxation has become another incentive that unnecessarily promotes new investment and job creation abroad.

Foreign business enterprises are often shocked to learn that while treaties may insulate them from federal taxation, state taxation can still be imposed. This factor, when combined with the ambiguity of current state tax nexus law and the aggressiveness of state tax administrators, has put a real damper on foreign investment. .

By providing a bright line, quantifiable physical presence standard, S. 2721, will encourage businesses, whether based in America or overseas, to put new investment and create new jobs here in America rather than in another country.

Conclusion

The physical presence nexus standard provides a clear test that is consistent with the principles of current law and sound tax policy[25] and that is consistent with Public Law 86-272, a time-tested and valid Congressional policy. Physical presence is an accepted standard for determining nexus.[26] And a physical presence test for nexus is consistent with the established principle that a tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer.

These comments only scratch the surface of why a physical presence nexus standard for business activity taxes and modernization of Public Law 86-272 is the right answer and why S. 2721 should therefore be enacted. But it is clear that S. 2721 warrants the full and enthusiastic support of Congress. CRAFT would be pleased to expand on any of the matters set forth above.

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[25] Richard Pomp, who testified as a tax policy expert on behalf of the taxpayer in *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 (Oct. 23, 2003), articulated "six principles of tax policy . . . as representing the values inherent in the commerce clause: desirability of a clear or "bright-line" test, consistency with settled expectations, reduction of litigation and promotion of interstate investment, non-discriminatory treatment of the service sector, avoidance of multiple taxation, and efficiency of administration." *Lanco Inc. v. Director, Div. of Tax'n*, N.J. Tax Ct., No. 005329-97 at 15-16 (Oct. 23, 2003). Professor Pomp concluded that a physical presence standard better advanced these principles than a standard based on economic nexus principles. *Id.* at 16.

[26] *See, e.g., Quill Corp. v. North Dakota,* 504 U.S. 298 (1992) and *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967).

International Council of Shopping Centers

Statement on Hearing Regarding: "How Much Should Borders Matter?: Tax Jurisdiction and the New Economy," In Support of S. 2152, the Sales Tax Fairness and Simplification Act July 25, 2006

By
Betsy Laird
Vice President, Federal Government Relations

1399 New York Avenue, NW
Suite 720
Washington, DC 20005
PH: (202) 626-1406
Fax: (202) 626-1418

International Council of Shopping Centers
1399 New York Avenue, NW Suite 720 Washington, DC 20005
202/626-1400 • Fax: 202/626-1418 • www.icsc.org

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* Executive Committee
◇ Past Chairman

July 25, 2006

The Honorable Craig Thomas
Chairman, Subcommittee on International Trade
Senate Finance Committee
U.S. Senate
Washington, DC 20510

Dear Chairman Thomas:

The International Council of Shopping Centers (ICSC) commends you for holding a hearing on "How Much Should Borders Really Matter?: Tax Jurisdiction in the New Economy", especially the matter of sales tax fairness and simplification, an important issue whose time has come.

The International Council of Shopping Centers (ICSC) is a strong supporter of S. 2152, "The Sales Tax Simplification and Fairness Act" and has worked at the state level to assist state legislatures simplify their sales and use tax systems. Founded in 1957, ICSC is the global trade association of the shopping center industry. Its has more than 61,000 members in the U.S., Canada, and more than 96 other countries who represent owners, developers, retailers, lenders, and other professionals as well as academics and public officials. Our U.S. members represent almost all of the 48,695 shopping centers in the country.

ICSC supports S. 2152 because it believes that government should treat all retail sales equally whether goods are purchased at a store on Main Street, at the local mall, over the Internet or through a catalog. Under current law some Internet retailers are paying nothing at all. Supporters of sales tax fairness believe Internet retailers should not enjoy tax avoidance at the expense of traditional retailers and state and local governments. ICSC applauds Senator Enzi's leadership on this issue. S. 2152 does not impose a new tax, it merely permits states to collect what is owed them from retailers in other states.

S. 2152 is good for consumers, businesses and the states. The legislation ensures fairness for consumers as needed tax dollars will stay in their communities, rather than funding public services elsewhere. The bill provides equal footing for local merchants who invest in our hometowns - - the local retailer who supports the area Little League team, allows Girl Scouts to sell their cookies outside their store and sponsors the area soccer club.

According to estimates prepared by the University of Tennessee's Center for Business and Economic Research in July 2004, states lost **$15.5 billion in uncollected taxes in 2003**. In 2008, that number is expected to reach between $21.5 and $33.7 billion if state and local governments remain unable to collect sales taxes from online purchases.

S. 2152 gives those states who have already simplified their sales tax codes a way to collect the billions of dollars currently owed. What if collecting taxes that are owed meant that a town or county would no longer have to raise property taxes or impose new fees? If states could collect the sales taxes owed, it's also possible their reliance on the federal government to provide funding for a myriad of projects could drop.

There is a small business exemption under S. 2152 for those who sell on-line. While this proposal works for the small time EBay seller or other small Internet business, keep in mind that similarly situated small "bricks and mortar" retailers do have to pay sales taxes and therefore face a competitive disadvantage.

Technology and current retail buying habits have eclipsed arguments made over a decade ago about why sales tax from out-of-state sellers could not be rightfully collected and remitted to the appropriate state. Low-cost technology does exist to help businesses calculate the amount of sales tax owed; one suspects that if S. 2152 was enacted, services like PayPal and others would scramble to adapt to the needs of the marketplace.

When the Supreme Court last considered the matter in the 1992 Quill case, it stated that allowing states to require tax collection on remote sales is an issue that "Congress ...has the ultimate power to resolve." Fourteen years later, that time has come. Thank you for your efforts to bring this important economic issue to the attention of the Subcommittee. ICSC looks forward to working with you and the Congress for enactment of S. 2152.

Very truly yours,

Betsy Laird

Betsy Laird
Vice President, Federal Government Relations

Iowa's Leading Business Tax Policy Resource
Since 1935

June 7, 2006

The Honorable Charles Grassley
United States Senator
135 Hart Senate Office Building
Washington, D C 20510-6200

Dear Senator Grassley,

The Iowa Taxpayers Association, the state's leading business tax policy resource, along with our member companies listed below, strongly support S 2721 - the Business Activity Tax Simplification Act of 2006 We respectfully ask your support for this important legislation and to schedule a hearing on this issue in the Senate Finance Committee

S 2721 would clarify the constitutional requirement for a physical presence nexus standard governing state assessment of corporate income taxes and other direct taxes on a business Specifically, the legislation would establish a bright-line physical presence standard that includes owning or leasing any real or tangible property, or assigning one or more employees to perform certain activities in the state for more than twenty-one days in a taxable year

This proposal is necessary to ensure fairness, minimize costly litigation, and to create the kind of legally certain and stable environment that encourages businesses to make investments, expand interstate commerce and create new jobs. The bill would ensure that companies continue to pay business activity taxes to states that provide them with direct benefits and protections

The Iowa Taxpayers Association appreciates this opportunity to share its position with you on this important issue Please feel free to follow-up should you have any questions

Thank you for your consideration of this request

Sincerely,

Iowa Taxpayers Association

ALCOA
Bandag, Incorporated
Brownells
Deere & Company
Harker's Distribution, Inc
HNI Corporation
Interpower Corporation
Iowa Bankers Association
Iowa Credit Union League

431 East Locust Street, Suite 300 ■ Des Moines, Iowa 50309
Voice: (515) 243-0300 ■ Fax(515) 243-2049
E-Mail: staff@iowataxpayers org ■ Web Site: www iowataxpayers org

Iowa Taxpayers Association
June 7, 2006

Iowa Network Services, Inc.
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Marshalltown Company f/k/a Marshalltown Trowel Company
Meredith Corporation
Muscatine Foods Corporation
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ONEOK Partners, L P
Pella Corporation
Principal Financial Group
Rada Manufacturing Company
Seiffert Lumber Company
Tru Art Color Graphics
United States Gypsum Company
Universal Engineering Corporation
Voltmaster Company, Inc.
Wilson Trailer Company

cc: Bob Renaud, State Administrator
Dean Zerbe, Finance Tax Counsel
David Young, Chief of Staff
Kolan Davis, Legislative Director

Multistate Tax Commission
444 North Capitol Street, NW, Suite 425, Washington, DC 20001-1538

STATEMENT OF THE
MULTISTATE TAX COMMISSION
REGARDING
"How Much Should Borders Matter?: Tax Jurisdiction in the New Economy"
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL TRADE
COMMITTEE ON FINANCE
UNITED STATES SENATE

AUGUST 8, 2006

The Multistate Tax Commission is an organization of state governments that works with taxpayers to equitably and efficiently administer tax laws that apply to multistate and multinational enterprises. Created by the Multistate Tax Compact, the Commission is charged with:

- Facilitating the proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;
- Promoting uniformity or compatibility in significant components of tax systems;
- Facilitating taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration;
- Avoiding duplicative taxation.

The Commission was founded in 1967. Currently forty-six states participate.

The Commission is grateful to the Subcommittee for providing this forum on such an important issue. It is especially grateful for the acknowledgement that Senator Thomas made in his opening remarks at the Subcommittee hearing on July 25, 2006:

> As a country that values its federalist system, we must take care to guard a state's ability to establish its own laws and exercise appropriate taxing jurisdiction, while at the same time ensuring that there is a clear line delineating where competition ends and discrimination begins. (page 2)

Unfortunately, the proposal known as the "Business Activity Tax Simplification Act," or S. 2721, crosses that line. By allowing large, multistate companies to avail themselves of means to avoid paying state business activity taxes, small, homegrown companies, such as community banks, are left at a severe competitive disadvantage. In the name of competition, small businesses in America, which are the backbone of job creation, would face economic discrimination.

That a large, multistate corporation could legally manipulate the system by setting up separate entities to own intangible personal property was recognized by Gary Imig, the direct marketing executive from Cheyenne, Wyoming, who testified at the July 25, 2006 hearing:

> I believe that we, as in industry, need to quit playing shell games. Nexus is Nexus. Setting up operations in separate companies, holding companies, etc. does not negate Nexus. We need to be honest in this. (page 5)

Courts have repeatedly upheld Mr. Imig's position that separate holding companies do not negate nexus. Under S. 2721, however, those court decisions would be overruled and the creation of separate holding companies could be used to avoid the obligation to pay state business activity taxes.

The testimony of Douglas L. Lindholm at the July 25, 2006 hearing, representing the Council on State Taxation (COST), sets forth a principle to guide decisions on state tax jurisdiction:

> Determination of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens—economic as well as administrative—only on businesses that receive meaningful benefits or protections from that government. (page 4)

Although COST reaches an opposite conclusion, it is easy to conclude that a multistate company with economic presence in a state receives benefits that the state has to offer.

- First, it benefits from an enhanced market when a state's residents are educated by a state educational system paid for by state revenues.
- Second, it benefits when it can adjudicate disputes in a state court system paid for by state revenues.
- Third, it benefits when its trucks travel on that state's roads. And
- Fourth, it benefits when that state's law enforcement officers keep the road safe to transport that company's goods.

Thus, under COST's own principle of state tax jurisdiction determination, there is no need for Congress to exercise its authority under the Commerce Clause of the Constitution to recognize physical presence as the nexus standard for state business activity taxes.

At the Subcommittee's hearing, Mr. Lindholm submitted a report from Ernst & Young, without a stated author, prepared for COST, and dated the day of the hearing. That report, entitled "Estimates of Impact of H.R. 1956 on State and Local Business Tax Collections," estimated that the fiscal impact of the Business Activity Tax Simplification Act would be a loss of $434,000,000 to the states. This figure, although significantly below the Congressional Budget Office (CBO) and National Governors Association

(NGA) estimates, is still not insubstantial on its face in that the Fiscal Year 2006 Unfunded Mandates Reform Act threshold is $64,000,000.

Of the three studies, only the NGA study had access to state tax returns so that the fiscal impact predictions could be based on actual figures and not extrapolations. Of course, the most glaring weakness of the COST estimate is that it fails to include any long-term impact analysis, stating that it is impossible to predict corporate taxpayer behavior after the adoption of the Business Activity Tax Simplification Act. This is simply a punt. Clearly, the long-term impact of S. 2721 (due to restructuring efforts) will be much larger than its short-term impact. The CBO's long-term impact figure ($3,000,000,000) is triple the short-term impact figure ($1,000,000,000). The NGA long-term impact figure ($6,600,000,000) is over double the short-term impact figure ($3,000,000,000). Doubling or tripling the COST short-term impact to produce a long-term impact estimate would produce a COST estimate figure more in the $1,000,000,000 range.

The COST estimate essentially relied on its own state by state estimates for twelve states (California, Florida, Georgia, Michigan, Minnesota, New Jersey, New York, Ohio, South Carolina, Texas, Virginia, and Washington) which COST claims represents 62% of the total state/local impact of BATSA. CBO estimated that a group of ten states (California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington) would receive 70% of the total BATSA impact upon the states. It is strange that the COST estimate excluded individual estimates for such large states as Illinois and Pennsylvania. By contrast, the NGA relied on the separate estimates received from thirty-four responding state revenue departments, with access to actual taxpayer data, in building its total impact estimate.

The variances between state-by-state estimates used by COST and NGA are huge. For instance, the COST estimate for the short-term impact of BATSA on Texas is a mere $20,000,000. The Texas Comptroller of Public Accounts puts it at $255,000,000. COST attempts to explain this discrepancy by stating that the NGA estimates were based on earlier versions of BATSA. The NGA estimate is dated September 25, 2005. Amendments to BATSA since then have been merely cosmetic and inconsequential.

CONCLUSION

The Multistate Tax Commission appreciates the opportunity to comment upon How Much Should Borders Matter?: Tax Jurisdiction in the New Economy. Our electronic 21st Century economy is borderless. S.2721 is a fuzzy line test that will promote corporate shell games, create endless litigation, costs state governments billions of dollars, and discriminate against small businesses. By contrast, the Multistate Tax Commission's Factor Presence Nexus test will create a fair, bright-line test that is better suited to the New Economy.

THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS (A BUSINESS ASSOCIATION)

SUBMITS THESE COMMENTS TO

THE UNITED STATES SENATE COMMITTEE ON FINANCE

August 1, 2006

Submitted by:

Michael Reilly
Chair, Taxation Committee

Andrew B. Breslow
Chair, Tax Legislative & Administrative Developments Subcommittee

Lynda K. Walker, Esq.
Vice President and International Tax Counsel

United States Council for International Business
1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org

TESTIMONY FOR SUBMISSION TO THE UNITED STATES SENATE COMMITTEE ON FINANCE ON INTERNATIONAL TAX REFORM AND US COMPETITIVENESS

The United States Council for International Business (USCIB) is pleased to present its views to the Senate Committee on Finance with respect to this extremely important subject of the need to reform the international tax regime of the Internal Revenue Code (the Code) to enable US multinational enterprises to enhance their international competitiveness vis-à-vis their foreign rivals. Although this hearing, and our statement, focus on the international aspects of the Code, many other, non-international provisions therein need re-examination and possible amendment, for the same reason.

The USCIB advances the global interests of US business, both here and abroad, including, in many instances, the US operations of non-US enterprises. It is the US affiliate of the International Chamber of Commerce (ICC), the Business and Industry Committee to the OECD (BIAC), and the International Organization of Employers (IOE). Thus, it clearly represents US business in the preeminent intergovernmental bodies, where the many and complex issues that face the international business community are addressed, with the primary objective being to search for possible resolutions to these issues. The bottom line in all of this is to ensure the existence of an open and equitable system of world trade, finance and investment.

Introductory Background

The US income tax system was first enacted in 1913, following its authorization by a Constitutional amendment. The system evolved over the years, by way of annual income tax acts, three codifications culminating in the 1986 Code, which is the basis of the statute today (the earlier codifications occurred in 1939 and 1954). From the beginning, the Code subscribed to the so-called **Classical** system, applied on a **Global** basis (these terms and concepts will be described below). For many and varied reasons, the Code has become antiquated, reflecting an inability to deal effectively and efficiently with the modern day business models and practices. Therefore, most pundits in the area would

United States Council for International Business
1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org

agree that the Code is in dire need of a thorough overhaul at this time. In fact, this was corroborated by the Bush Administration, which gave a high priority to a fundamental tax reform project and appointed a blue ribbon panel (the Panel) to conduct such a study. (USCIB submitted a commentary to this Panel during its deliberations, which submission contained our thoughts and suggestions on this topic, many of which will be mentioned below.) Although this statement deals primarily with the international provisions of the Code, as mentioned above, the domestic provisions need a thorough, critical review as well.

Conclusions

Before commencing with a detailed discussion, it would be useful to outline briefly the relevant goals that USCIB would envisage be accomplished by a major reform of the Code's international tax regime. These are set forth below.

- A reformed tax system should aim to depart completely from the old Classical model, which doubly taxes corporate income, and, in its place, shift to an integrated system, which avoids multiple levels of income tax on the same income.
- A reformed international tax regime should **not** result in an increase in the tax burden of US multinational enterprises. Thus, nominal tax rates should be reduced, not increased, and the situation where US multinationals encounter residual US tax on foreign source income after application of the foreign tax credit provisions should be the exception rather than the rule.
- A reformed tax system should be broad based, and it should, thus, apply consistently across industry lines. In other words, it should not discriminate against certain industries or specified groups of taxpayers. In addition, the revised regime must offer consistency in tax treatment to all forms of business organization availed of by multinational taxpayers to conduct business operations abroad, whether it be a controlled foreign corporation, a branch, a partnership, a joint venture (e.g., a 10/50 company), etc., so as not to unfairly

penalize any taxpayer for selecting one form of business organization over another, presumably, for valid business reasons.

- A reformed international tax regime should ideally eliminate, but, at the very least, substantially cut back the reach of, the Code's Subpart F provisions, so as to restore the sanctity of the principle of deferral with regard to US taxation of foreign income earned through associated overseas entities. In other words, the acceleration of taxation of overseas non-repatriated earnings, including the active income of a foreign subsidiary of a US based financial services enterprise, puts US multinationals in a competitively more disadvantageous position than non-US multinationals. Also, in this vein, an appropriate definition of "passive" income should be carefully crafted so as not to subject to tax, in the guise of passive income, what is really active business income, prior to repatriation (e.g., royalties from intangibles and technology developed by a taxpayer for use in its trade or business).
- A reformed international tax regime should strive to minimize, if not totally eliminate, international double taxation by offering to US multinational enterprises a **true** overall foreign tax credit limitation approach. In other words, the fracturing of the limitation into many different categories (baskets) defeats the goal of providing maximum relief from international double taxation, and adversely impacts the competitive position of US enterprises. Moreover, for the same reason (i.e., competitiveness), the regime should simplify and ease the requirements and relevant rules in allocating and apportioning expenses to foreign source income. The alternative approach to providing double tax relief is the so-called territorial (i.e., exemption) approach, which is very popular among the European (and certain other) countries. The particular exemption system proposal currently under consideration in the USA is generally not favored by the USCIB membership; however, it is important to note that, if structured appropriately, territoriality could achieve the desired goals.
- A reformed international tax regime should fully support and encourage the enhancement of the US tax treaty program, and strive to introduce into it

innovative concepts which will serve the interest of minimizing double taxation for all taxpayers, US and foreign.

- A reformed international tax regime should retain the "place of incorporation" standard as the sole standard for determining corporate residency; a "place of management" test, as an alternative or replacement, is undesirable.

The discussion to follow will illuminate many of the above points.

Classical Model and Double Taxation of Corporate Earnings

The United States has followed the Classical system model since the inception of the US tax law. Under such model, net corporate income after corporation income tax is again subjected to income tax in the hands of shareholders, with the exception of dividends eligible for the inter-corporate dividend exemption. The ultimate individual shareholders are subject to tax on corporate dividends, which are almost always paid out of income already taxed at the corporate level.

In contrast, many, if not most, of our trading partners, i.e., those nations in which the competitors of our US multinational enterprises are domiciled, use some form of integrated tax system (there are several different methods of achieving an integrated system, but the imputation model has, over the years, been the most popular). Multinational enterprises which are resident in countries having integrated tax systems may well enjoy a competitive advantage over US multinationals by reason of not being subject to the double taxation of corporate income as under the Classical model.

Over the years, legislative efforts have been made, from time to time, to reduce the incidence of double taxation of corporate profits, through a combination of dividend credits and exemptions, most of which were repealed because of revenue concerns. The latest move to redress this flaw in our system took place in the 2003 tax legislation, i.e., the Jobs and Growth Tax Relief Reconciliation Act, which imposed a tax of 15% on portfolio dividends in lieu of a resident taxpayer's invariably higher

marginal rate. This is indeed a step in the right direction of achieving a fully integrated system; but full integration, comparable to that in many of our trading partners, is still the ultimate goal in this area. In our view, it would be a simple matter, at this point, of completing the job that the 2003 legislation started, and to provide, legislatively, for a zero rate on portfolio dividend income. End of story!

Although one might consider this issue more in the area of domestic tax policy, the elimination of the double tax on corporate income would make the Code more consistent with the approach of our trading partners and, thus, perhaps, tend to level the playing field for US multinational enterprises.

Overall Tax Burden Concerns

In devising a rational and user-friendly international tax regime for US multinationals, one that will enhance their competitive standing in the world, there are two major overall themes that should be considered as guiding principles behind any proposed detailed technical legislative amendments. First of all, whatever shape reform in the international tax regime might take, the drafters of the statutory language must be sure that the changes do not impose higher tax burdens on US multinational enterprises than now exist. This may seem like a simplistic statement, and it may be; but, in a proposal for reform in the international area developed by the Joint Committee on Taxation in 2005, in which the JCT recommended replacing the current system with a territorial system for mitigating international double taxation, the scheme so presented resulted in a tax increase of over $50 billion on the population of US domiciled multinationals. This has to be carefully avoided, or the cure will be worse than the disease.

Again, as a matter of domestic tax policy, if the rates of corporate tax must be tinkered with, they should not be raised so as to increase the tax burden. Ideally, they would be lowered, as the USA is today one of the higher tax countries in the world. (A tax decrease on multinational enterprises, in fact, could well have a salutary impact on the economic well being of the USA.) Moreover, we submit that

US multinationals should be in a position in which there is rarely any residual US income tax on their foreign earnings. This can be achieved by way of a properly constructed foreign tax credit provision or a carefully tailored territorial system.

The second guiding principle is that of consistency of treatment across the board. The tax system, as well as the international tax regime therein, should be broad based, and, in accord therewith, have equal application across industry lines. In other words, the regime should not single out specific industries or groups of taxpayers for special, usually discriminatory, treatment. Consider the current foreign tax credit provisions, which contain (in Section 907) punitive rules with respect to the petroleum industry, treating that industry more harshly in terms of additional limitations on their foreign income taxes which are available for the foreign tax credit. The standard of consistency also should apply to alternative forms of organization. Whatever form of organization a US multinational enterprise elects for the conduct of its overseas business activities, be it a controlled subsidiary (a wholly-owned or majority-owned controlled foreign corporation), a branch, a partnership, or a joint venture (e.g., a minority-owned controlled foreign corporation or a non-controlled foreign corporation (a 10/50 company)), it should be subjected to similar tax treatment. The choice of form of organization is, in general, a business decision rather than a tax driven one.

Deferral/Controlled Foreign Corporation Rules

The principle of deferral has been an underlying tenet of the tax statute virtually since inception of income taxation in the USA. Deferral is nowhere defined in the statutory language, but it is implicit in the structure of the law. Essentially, it stands for the proposition that earnings amassed by the overseas affiliates of a US taxpayer are not includible in the income of such taxpayer as earned, but only as actually paid out, or otherwise made available to, the US taxpayer. In other words, the income as earned by a foreign affiliate is deferred from US tax as long as it remains in foreign corporate solution.

In the United States, the principle of deferral was first violated by the introduction into the statute, under the 1939 Code (pre-1954), of the Foreign Personal Holding Company (FPHCo) provisions. This set of rules, together with its companion piece, the Personal Holding Company (PHC) provisions, targeted the incorporated pocketbooks of high net worth individuals who were attempting to reduce their personal tax burdens by shifting passive income-producing assets into corporate solution, either domestic (PHCo) or foreign (FPHCo). These provisions had no real effect upon publicly held US multinational enterprises. It wasn't until 1963, courtesy of the Revenue Act of 1962, when the Controlled Foreign Corporation (CFC) provisions became effective that the large US international corporations began to feel, to a degree, the impact from a partial ending of deferral. These CFC rules introduced into the Code a novel concept, that of taxing all US taxpayers, including the large multinationals, on certain specified income earned by CFCs in which such shareholders held a greater than 10 % voting interest. These new provisions went beyond the PHCo/FPHCo attack on passive income held by a closely-held corporation (i.e., the so-called corporate "pocketbook"), although passive income was included as an item of income to be covered under the new regime.

The main thrust of the CFC rules, in brief, was to treat low-taxed income earned by CFCs as dividends to the US shareholders. It was aimed at preventing US multinational enterprises from enjoying the tax deferral benefits arising from the use of tax havens or special tax incentive provisions in non tax haven jurisdictions to conduct bona fide business activities (e.g., product sales, services, etc). It is quite easy to see just how these changes adversely affected the competitiveness of US business abroad, even at a time when the USA still dominated the world economy. Unfortunately, in the years since the Revenue Act of 1962, Congress has enacted a plethora of ill conceived, onerous amendments to Subpart F, having little relationship to the original purpose of the provisions, resulting in a further erosion of the competitiveness of US business abroad. Although many other capital exporting nations have since enacted their versions of the CFC concept, the US version is, by far, the most burdensome to its multinational community.

United States Council for International Business
1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org

The 2004 tax legislation did redress some of the issues and problem areas in the CFC rules. But what is really needed to shore up the competitive vigor of US international enterprises is a complete repeal of the Subpart F provisions. The USCIB strongly supports this, which, in conjunction with the changes in the double taxation relief rules, to be discussed below, is just what the doctor ordered to cure the competitive ills of US business abroad.

International Double Taxation Relief

****Credit Approach**

Doubtlessly, the most important set of provisions in the Code with regard to restoring and enhancing the competitiveness of the US multinational community is the set of provisions aimed at granting such enterprises relief from the scourge of double taxation (by two or more jurisdictions) on the same income streams. The provisions so designed to carry out this mandate encompasses the actual foreign tax credit mechanism (Sections 901-907 and 960) and the related expense allocation and apportionment principles (regulations under Section 861 and 862). The existence of a flexible and efficient system for the elimination of international double taxation is, in essence, the cornerstone upon which is built a suitable international tax regime for US multinational enterprises.

Initially, the foreign tax credit regime offered a country-by-country limitation (referred to in the Code as the per-country limitation), under which a taxpayer would be limited in the amount of foreign tax credit allowable each year to the aggregate of the amounts of US tax attributable to the taxable income from each foreign country in which the taxpayer incurred foreign income taxation. In 1960, effective for calendar year 1961, the Congress enacted an overall limitation to replace, after a transitional period in which both limitations were in the law, the per-country limit. This mechanism, which allowed for the averaging of all foreign income taxes, irrespective of the source country or the nature of the activity giving rise to such income taxes, proved to be an a very effective shield for US corporations against the

burdens of double taxation, in terms of maximizing the foreign tax credit relief and, thereby, minimizing the tax burden (US and foreign) on foreign source income. The ink was barely dry on the legislation enacting the overall approach when Congress took its first baby step toward diluting it by enacting a separate limitation on certain passive interest income. From then on, Congress kept chipping away at the effectiveness of the overall limit, culminating in the 1986 Code which established a series of separate limitations with the result that the overall limitation existed in name only, not in fact. Naturally, the competitive position of US business was severely compromised by this development.

Like in the deferral area, the 2004 tax legislation provided some relief by reversing some of the mischief created to the overall limit in the previous Congresses. But more needs to be done to truly re-establish a level playing field for US multinationals. This should be a two-pronged program. First, the overall limitation needs to be reborn in its original (1960) configuration, i.e., absolutely no separate limitations, not for passive income nor any type of operating income (e.g., oil and gas income covered now under Section 907). The second prong relates to expense allocation and apportionment which is discussed in the ensuing two paragraphs.

Having a reasonable set of expense allocation and apportionment rules, for foreign tax credit purposes, is as important to US multinationals in ensuring competitiveness abroad as having a monolithic (non-fractured) overall foreign tax credit limitation. If anything can dilute the efficiency of the overall foreign tax credit relief, it would be an arbitrary and unreasonable set of rules for allocating and apportioning expenses against foreign source income to arrive at foreign source taxable income, the numerator of the foreign tax credit limitation fraction. We were pleased to see the amendments enacted in the 2004 tax act introduced very sensible rules in the allocation and apportionment of interest expenses, which previously had been tilted unfairly against maximizing allowable foreign tax credits, as well as in the allocation and apportionment of general and administrative expenses. Such sensible rules should be retained and a similar approach should be utilized with

United States Council for International Business
1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org

respect to all other expense categories that require allocation and apportionment against foreign source income.

****Exemption Approach**

An alternative to the credit approach is the exemption approach, often referred to as the territorial method. This method has been under intense scrutiny of late having been the subject of a US Treasury Department study as well as the recommended approach of the Presidential Advisory Panel on Tax Reform. In addition, a blueprint for such a system has evolved from a Joint Committee on Taxation (JCT) study thereof. In broad outline, the territorial system would operate to exempt US enterprises from income tax on the business earnings of their overseas entities, including subsidiaries, branches, joint ventures, etc., while continuing to tax them on their so-called passive income where the foreign tax credit mechanism (probably on a per-item basis) would operate to eliminate the double tax on such income. The USCIB does not concur with a territorial system modeled along the lines of the JCT blueprint. If, however, a territorial system structured in the manner of those in use in certain of our trading partners (e.g., the Netherlands, France) were to be established, it could well achieve similar results, i.e., relieving double taxation as discussed in the immediately preceding section. Otherwise, retention of our present system will be more apt to enhance our nation's competitive position vis-à-vis these competitor nations.

It is important to note that the territorial system is only about mitigation of the potential international double taxation burden that arises from engaging in cross border trade and investment, nothing more. The question is: does this system more effectively provide for US multinational enterprises the maximization of double tax relief, and, therefore, the minimization of global tax burdens? The answer to this question depends upon the structure of the particular territorial model selected. We believe, however, that a territorial system installed in the Code for the purpose of raising additional tax revenue for the Government would be a very unfortunate development.

United States Council for International Business
1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org

Should a territorial system be adopted, a number of industry specific issues will emerge. For example, for the financial services industry, the most important international issue is the allocation of interest. Careful attention must be paid to developing rules that do not result in the loss of interest deductions to members of the financial services community. In particular, the tax systems of our major trading partners and OECD countries must be analyzed to understand how they treat interest expense so our financial institutions are not put at a serious competitive disadvantage.

If one were to initially construct a tax system today, it would be a very close call as to whether to opt for a credit system or an exemption system. The answer would evolve about the design of the credit mechanism vs. the design of the territorial exemption and the comprehensiveness of the relief produced by each such approach. Although the territorial method would appear to enjoy the virtue of simplicity, this can be misleading. Simplicity may be desirable, but it is not the primary goal, which is the effectiveness of a system in minimizing the double taxation burden. It should be noted that the credit system, even if amended as we suggest above, is very familiar to the managements of US multinationals, and, in particular, to the tax departments of these enterprises. Thus, taxpayers would be knowledgeable with all the nuances of the system and comfortable with its application. There would be no growing pains to suffer as there no doubt would be in implementing a whole new approach to double tax relief, which, although its proponents claim is simpler, does have its own complexities.

In addition, the transition from the present system to a territorial system, involving an exemption from tax for business income and a foreign tax credit for other income, would, we estimate, be initially burdensome on the tax department resources of the US multinational community, both financial and human. Also, there may have to be some very complex transition rules with regard to the phase-out, over a relatively long period of years, of the existing foreign tax credit rules so as to permit taxpayers the opportunity to somehow utilize credits accumulated in

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1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org

years in which the old system was in force. As a corollary, this would probably necessitate a gradual phase-in of the new system. The change thus could be a long, drawn-out affair, replete with complications as the two systems operated in tandem. This factor alone, although not as significant as the comparative effectiveness of the two approaches, could be enough to substantially erode support for such a conversion at this time.

Importance of Tax Treaties

Tax treaties have been with us since the 1930's. The number thereof and their importance has increased tremendously over the years. The foreign tax credit (as well as territoriality) is a unilateral approach to the elimination of international double taxation, while treaties present a bilateral approach for, *inter alia,* accomplishing this goal. All interested parties, government, business, investors, etc., support a vigorous, proactive and innovative treaty policy. In the context of these hearings, it should be said that any legislation addressing the reform of our international tax regime should be carefully structured to ensure consistency with this goal of enhancing our international treaty program.

Corporate Residence

We noted that the Presidential Panel, in its report of November, 2005, made a recommendation to alter the long standing definition in the Code of corporate residence. We do not concur with the Panel on this matter, and we wish to express that concern here in the event that this Subcommittee (or its parent, the W&M Committee) might decide to consider and recommend the Panel's position on this issue.

Since inception of the US income tax law, the test of corporate residence has been the place of incorporation. Accordingly, an entity organized under the laws of one of the fifty states of the USA (or under US federal law) was a US corporation, and, thus, resident, so to speak, in the USA. This is a straight-forward objective test, simple to apply. The Panel has recommended adding to the mix an additional, much

more ambiguous, standard, i.e., the place at which the entity is managed and controlled. This so-called "mind-and-management" test is, admittedly, used in more countries than anything comparable to our standard, but that doesn't make it right. This mind-and-management standard was developed under the legal principles of the United Kingdom. Under it, one looks to various indicia in an effort to establish the place from which the entity is managed and controlled, and thus resident.

The Presidential Panel recommended that the management and control test be included in the Code, in addition to the place of incorporation test. In other words, all US incorporated entities would be US residents by way of the long standing rule, while all non-US incorporated enterprises would be tested under the new management and control standard, however that would be implemented, if enacted. Although it seems clear that the new standard would be aimed squarely at foreign controlled enterprises doing business in the USA, it could prove to be a pitfall for US controlled enterprises as well, since it could easily be used by the IRS to assert a US residence with respect to their CFCs. Accordingly, we see the potential for such a change in the corporate residence test to give rise to much controversy with the IRS, both with foreign controlled enterprises operating in the USA and US controlled enterprises as to their CFCs. If this comes to pass, such additional controversy will no doubt lead to more, needless, costly (both to the IRS and taxpayers) litigation. The key consideration in this context is the possibility that a US enterprise's CFCs could be treated as US residents, for US tax purposes, thus negating the benefit to US competitiveness that will result if our recommendations on international tax reform discussed above with respect to deferral and controlled foreign corporations are taken seriously.

An interesting observation to be noted, in the context of this discussion, is the distinct possibility that an amendment to the corporate residence rule along these lines would probably discourage decision-making executives of foreign enterprises engaging in US business activities from residing in the US. Although such an eventuality might not have an adverse impact on the competitiveness of US

business, it could certainly have an adverse effect on inbound foreign investment in the US, which is not necessarily a good thing for the US economy.

Conclusion—A Final Note

In conclusion, we would urge the legislators to seriously consider the arguments and suggestions discussed above with respect to the Code's international tax regime in their effort to re-establish the strong competitive position internationally of the US business community.

We would further suggest that, as part of this review, tax reform should also look at competitiveness of the US economy. In other words, whatever reform legislation emerges from this current exercise, it should attempt to render, and retain, the US economy as a user friendly jurisdiction in which to establish business operations. Over the years, our country has been a leader in attracting foreign investment. As the global economy, hopefully, continues to expand, we face increasing competition from other countries for this investment, which, of course, means that we should strive to eliminate tax policies and rules that discriminate against foreign investment. After all, foreign investment in the USA creates jobs for US workers just as domestic investment does. It must also be said, in this vein, that tax legislation that discriminates against foreign investors tends to breed the enactment of similar measures by our trading partners which would act against the best interests of US enterprises operating or investing internationally.

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We thank the members of this Committee for the opportunity to present our views on this subject of utmost importance to our membership, to the US multinational community and to the well being of the US economy, in general.

United States Council for International Business
1212 Avenue of the Americas, New York, New York 10036-1689
Tel: 212-354-4480 Fax: 212-575-0327 E-mail: info@uscib.org Internet: www.uscib.org