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Updated July 7, 2015

Proponents' Case for Federally Imposed Business Activity Tax Nexus Threshold Has Little Merit

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A bill under consideration in the U.S. House of Representatives would strip states of their current authority to tax a fair share of the profits of many corporations that are based out of state but do business within their borders. The House Judiciary Committee approved the "Business Activity Tax Simplification Act of 2015," ("BATSA", H.R. 2584) on June 17. As this report explains, the sometimes reasonable-sounding arguments offered in support of the legislation have little merit and serve primarily to obscure the corporations' straightforward goal of cutting their state taxes.

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 New Hampshire Business Enterprise Tax (a form of value-added tax), the Texas Franchise Tax (a tax on businesses' "gross margins"), and the Washington Business and Occupation Tax and the Ohio Commercial Activities Tax (both are taxes on businesses' 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 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.

A companion CBPP 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," updated June 18, 2015, http://www.cbpp.org/sites/default/files/atoms/files/6-24-08sfp.pdf; hereafter referred to as "CBPP's analysis of BATSA.") That report focuses on the adverse impact of BATSA on the

revenue-raising capacity and fairness of state corporate income taxes. This report has a different objective: to rebut the key claims made by the proponents of BATSA as to why it is necessary.

General Claims About Why the Bill Is Needed

***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. They 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 clearly benefit 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 houses are 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 likely benefit more from public services when they have more workers and property 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.[1]
- 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 "codify" federal and state court decisions strongly implying that "physical presence" is the nexus threshold for BATs under the U.S. Constitution, because a small number of recalcitrant, aggressive states refuse to accept the clear message being sent by the courts.

Rebuttal:

- Two U.S. Supreme Court cases, *Whitney* v. *Graves* (1937) and *International Harvester* (1944), make clear that a person or business receiving income with a source in a particular state need not be physically present in that state for the state to tax the income. Perhaps with these cases in mind, the U.S. Supreme Court stated in its 1992 *Quill* decision: "[W]e have not, in our review of other types of taxes, articulated the same physical-presence [nexus] requirement . . . established for sales and use taxes."[2]
- State courts are split on whether a state can impose a BAT on a non-physically-present business, but 12 state courts have held that they can, while only two have held that they can't.[3] Moreover, five recent cases that sided with the states' position that physical presence is *not* required for BAT nexus were appealed to the U.S. Supreme Court, and in each case the Court declined to review the decision.[4] If, as BATSA proponents claim, state laws asserting that physical presence is not required for BAT nexus are "constitutionally questionable," the U.S. Supreme Court has had ample opportunity to strike them down.

Claim:

BATSA is needed to reverse those 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:

- As explained above, 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, identify every one of its products and its customers as taxable or tax-exempt, and program its accounting system to charge taxable customers the proper tax. (Then, of course, it must actually collect the tax 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 at the *end* of its tax year. 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 the purchaser owes and the state could, in theory, collect directly from the purchaser (albeit with fairly intrusive auditing). In contrast, a BAT is the legal liability of the business 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, since states have the right to tax income earned within their borders by individuals and businesses alike (and not even BATSA proponents propose that they be stripped of this long-established right), and since businesses can earn such income without being physically present, it is illogical to bar states from taxing that income merely because the business is not physically present within the state.

Claim:

The principles of federalism embodied in the U.S. Constitution, which vests in Congress the authority to regulate interstate commerce, demand that Congress enact legislation to establish a uniform national BAT nexus standard.

Rebuttal:

- No one questions the authority of Congress to enact BATSA; the debate is over the wisdom of its doing so.
- "Federalism" does not merely concern the mechanical division of authority between the federal government and the states. It also encompasses notions of deference and comity toward states on the part of the federal government. State and local governments are partners with the federal government in providing essential government services like education, health care, and transportation, which they cannot provide if their powers of taxation are unduly and unnecessarily interfered with. Congress has enacted several laws limiting state taxing powers that have spawned substantial, costly litigation and led to adverse, unanticipated consequences for states because Congress did not take adequate care in drafting them. BATSA has the potential for many such problems. Congress should therefore give great deference to state tax policies absent a compelling showing that they are contrary to the national interest.
- Federalism is often justified as a means of keeping government "close to the people" so that elected officials can be held accountable to citizens. Federal preemption of state taxing powers violates this goal, because it enables Congress to provide tax cuts to business interests at state expense with no accountability for any adverse consequences. State officials, not members of Congress, will be blamed if public services are reduced or household taxes are increased to compensate for tax cuts provided to businesses by BATSA. Thus, the enactment of BATSA would undermine a key objective of federalism.

Claim:

BATSA is needed to stop states from asserting that they have the right to tax corporations that do not produce goods or services 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 undo a more than half-century-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 (MTC, 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.[5] Thus, the claim that "corporations only earn income where they produce, not where they sell" is inconsistent with the explicit position taken by many of the bill's proponents as recently as 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/sites/default/files/atoms/files/1-26-05sfp.pdf).

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 further demonstrates 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/sites/default/files/atoms/files/1-26-05sfp.pdf.)

- Moreover, a significant number of policymakers question the continued appropriateness of the current PE standard for national-level corporate income taxes. As part of its effort to stem widespread corporate income tax "base erosion and profit shifting" (BEPS), for example, the Organisation for Economic Co-operation and Development (OECD) is considering major changes in PE rules. As a recent OECD BEPS task force report noted:

> Nowadays it is possible to be heavily involved in the economic life of another country, e.g. by doing business with customers located in that country via the internet, without having a taxable presence therein (such as substantial physical presence or a dependent agent). In an era where non-resident taxpayers can derive substantial profits from transactions with customers located in another country, questions are being raised as to whether the current rules ensure a fair allocation of taxing rights on business profits, especially where the profits from such transactions go untaxed anywhere.[6]

Accordingly, the OECD has determined that:

> The definition of permanent establishment (PE) must be updated to prevent abuses. In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by "commissionnaire arrangements" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs [multinational enterprises] may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.[7]

It is ironic that even as the OECD is close to approving rule changes restricting corporations' ability to use "independent" agents and corporate subsidiaries to avoid establishing nexus in countries where they earn profits, BATSA proponents are citing PE rules to justify legislation that would vastly *expand* corporations' ability to adopt the same kinds of tax-avoidance practices at the state level.[8]

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 14 days in a tax year without creating nexus is such a reasonable "*de minimis*" threshold.

Rebuttal:

- The 14-day safe harbor is 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 14 days from all BATs, while a corporation with just one employee in the state for 15 days could be required by a state to pay the BAT. Clearly, the first corporation benefits more than the second corporation from police, fire, transportation, and other services provided to its employees, yet BATSA exempts only the former 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 inventory in a state that is being stored at an order-fulfillment warehouse run by a business like UPS or Federal Express does not create nexus under BATSA, but owning a building in the state that is worth a million dollars does create nexus. There is no reason to believe that the value of police and fire protection 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, enacted by Congress in 1959, 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 as 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 — all of which receive police and fire protection — 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 more than 25 years ago.[9] 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" 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 taxing 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 http://www.cbpp.org/sites/default/files/atoms/files/6-24-08sfp-appendix.pdf, pp. 5-6.)

Claims about Alleged Harm That BATSA Will Stop

Claim:

By establishing a clear, nationally applicable, physical-presence nexus standard, BATSA will substantially reduce nexus-related litigation.

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 declares that nexus is not created by the in-state "conduct [of] limited or transient business activity" but does not define "limited" or "transient." 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 much more far-reaching and complex.
- A comprehensive law review article documented 57 reported court cases involving disputes over the application of P.L. 86-272 as of 2003, and occasional cases have occurred since.[10] BATSA proponents can cite approximately 20 BAT nexus cases that do not involve P.L. 86-272.[11] 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 false.
- As documented in CBPP's analysis of BATSA, enactment of the bill 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 as one corporation for tax purposes but rarely use it because doing so entails a heavy burden of proof that usually invites litigation. Because of the damage that BATSA would do to their revenues, states are more likely to use this discretionary "combined reporting" 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 more than 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.[12]

Claim:

BATSA is needed to prevent "double taxation" of corporate income, which is burdening corporations and stifling commerce.

Rebuttal:

- Proponents of BATSA have not provided any concrete examples of corporations subject to double taxation of their income. And, as another CBPP report explains, BATSA is likely to vastly increase the share of U.S. corporate profit that is "nowhere income" not subject to tax by *any* state. (See: http://www.cbpp.org/sites/default/files/atoms/files/1-26-05sfp.pdf)
- Restricting state taxing jurisdiction is an unnecessary and excessive mechanism for preventing double taxation of corporate income in any case. States can substantially eliminate the potential for such double taxation by adopting uniform "apportionment" rules governing the division among the states of the profits of multistate corporations. Yet as documented in the report cited in the previous paragraph, many BATSA proponents have pushed states toward *non*-uniformity in their apportionment rules. In short, offering "double taxation" as a justification for BATSA is both unsupported by facts and hypocritical.

Claim:

BATSA is needed to prevent "taxation without representation." Businesses have no political representation or influence in states in which they have no physical presence and will face unfair tax burdens if they are subject to taxation in such states.

Rebuttal:

- This argument has been forcefully rebutted by leading state tax experts Walter Hellerstein of the University of Georgia Law School and Charles McLure of Stanford University's Hoover Institution.[13] They note that corporations don't have the right to vote. In addition, states have an unquestioned right to tax the income earned within their borders and property owned there by non-resident *individuals,* who also don't have the right to vote in states in which they are subject to taxation. In short, "no taxation without representation" as an argument for BATSA is a red herring.
- Hellerstein and McLure also observe that because the courts have made clear that states may not discriminate in their tax policies against out-of-state businesses, lobbying by in-state businesses (which clearly do have significant political influence in a state) against onerous tax policies also protects the interests of out-of-state businesses.

Claim:

There is a disturbing trend of states raising revenues through aggressive assertion of nexus over out-of-state companies with little or no presence within their borders, which the states then use to finance economic development tax breaks to corporations with substantial property or employees within the state. BATSA is needed to stop such discrimination in favor of in-state firms at the expense of out-of-state firms.

Rebuttal:

This is an ironic argument for BATSA proponents to make:

- A number of corporations supporting BATSA have worked actively for an increasingly common change in state tax policy that, in the name of economic development, is explicitly aimed at shifting the corporate income tax burden off of corporations with a substantial physical presence in a state and on to out-of-state corporations with little physical presence in a state. (See: http://www.cbpp.org/sites/default/files/atoms/files/1-26-05sfp.pdf.) For example, Bayer Corporation, Dick's Sporting Goods, General Electric, The Walt Disney Company, and Johnson & Johnson are members of coalitions that have actively lobbied for this policy (a "single sales factor apportionment formula") in Pennsylvania and California.[14]
- Many business organizations supporting BATSA also sought the enactment of the "Economic Development Act of 2005" (S. 1066/H.R. 2471). The goal of this bill was to preserve existing state economic development tax incentives. The EDA was aimed at stopping challenges to tax incentives based on the argument that they discriminate against out-of-state businesses in violation of the Constitution's Commerce Clause. In other words, the many BATSA proponents that also supported the EDA tried to *preserve* the right of states to discriminate in favor of in-state businesses by providing them with tax breaks.
- BATSA itself has one provision that intentionally discriminates against certain out-of-state businesses in the name of state economic development. In order to help states drum up business for in-state corporations from out-of-state corporations, BATSA declares that physical presence in a state in connection with *purchasing from* an in-state business is not nexus-creating. This provision discriminates against out-of-state businesses that may have an equivalent number of employees or an equivalent amount of property in a state but will not be exempted from state taxation by BATSA because that physical presence is involved in *selling to* an in-state business.

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 impedes 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 sellers of physical goods, and state tax officials can't get around it no matter how "aggressive" they might like to be. And, 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 majority of court cases and enforcement actions 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.[15]

- For the entire 15-year period that BATSA has been under consideration in Congress, its proponents have claimed that its rapid enactment is urgent because the allegedly aggressive assertion of nexus by state tax officials is chilling interstate commerce.[16] Yet with millions of businesses operating in the United States, BATSA proponents have cited only a single concrete example of a company that allegedly 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.[17] It is highly unlikely that large, national businesses are constraining their own growth by not doing business in particular states because of BAT nexus issues. Are national fast-food chains refusing to license franchisees in particular states because of fears of assertion of nexus over the franchisor? Are national banks refusing to 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 lack credibility.
- If anything, the enactment of BATSA is likely to harm the economy by providing a *disincentive* for optimal business location decisions. As the former 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.[18]

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 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 discouraging foreign direct investment here. While such investment fluctuates

enormously over the business cycle and remains below the peak year of 2000, it rose fairly steadily from 2002 through 2008, when the Great Recession took hold. Since then it has 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.[19]

Notes

[1] Two leading experts on state taxation concur:

> This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible. A profitable corporation clearly enjoys both types of benefits. It is true that in-state corporations may receive greater benefits than their out-of-state counterparts, for example, because they have physical assets that need fire and police protection. But that is a question of the magnitude of the benefits and the tax that is appropriate to finance them — something that is properly addressed by the choice of apportionment formula and the tax rate, not the type of yes/no question that is relevant for issues of nexus. The answer must clearly be a resounding yes to the question of whether the state has given anything for which it can ask in return.

Charles E. McLure Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004, p. 721. The article was sponsored by the National Governors Association. McLure is a Senior Fellow with the Hoover Institution at Stanford University and was Deputy Assistant Secretary of the Treasury for Tax Analysis during the Reagan Administration. Walter Hellerstein is Francis Shackelford Professor of Taxation at the University of Georgia Law School and author of the most well-known legal treatise on state taxation.

[2] It is true that the *Whitney* and *International Harvester* cases focused on whether New York and Wisconsin, respectively, had the right to tax the income of the out-of-state recipients rather than assert taxing jurisdiction over the recipients themselves. It is also true that both cases were decided before *Quill* articulated a novel legal principle that the Due Process and Commerce Clauses of the Constitution imposed their own — and different — nexus requirements for state taxation of out-of-state corporations. Nonetheless, given the Court's explicit statements in *Quill* that its earlier cases had not established a physical presence nexus threshold for taxes other than the sales tax, it arguably is more likely than not that states have the authority under current constitutional law, at least in certain circumstances, to impose business activity taxes on income earned by non-physically-present companies.

That conclusion was supported by the late Jerome Hellerstein, widely recognized as one of the preeminent experts of the last 50 years on constitutional law bearing on state taxing authority. In an article written *after* the *Quill* decision, he stated: "The U.S. Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is *not* essential to the state's income tax on income of a nonresident."

In short, the Supreme Court determined long ago that, at least in certain circumstances, it is entirely fair for a state to tax the income earned within its borders by a non-physically-present person or business.

[3] Courts in Illinois, Indiana, Iowa, Louisiana, Maryland, Massachusetts, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina, and West Virginia have held that physical presence is not required for BAT nexus. Courts in Tennessee and Texas have held that it is. A Missouri case cited by BATSA proponents as supporting their position was decided on state law grounds having nothing to do with nexus under the Constitution. An Alabama case they also cite was effectively reversed by a subsequent decision. Recent decisions in Indiana, New Jersey, Oklahoma, and West Virginia held that physical presence was required for nexus under the specific facts of the cases but did not overrule previous cases in each state finding that physical presence is not inherently required.

[4] State court decisions in Iowa, Massachusetts, New Jersey, North Carolina, and West Virginia that upheld the states' positions that a business need not be physically present in a state to have BAT nexus there were all appealed to the U.S. Supreme Court. The Supreme Court denied review in all five cases.

[5] See a letter dated November 11, 1995 from Fred E. Ferguson of Arthur Andersen representing the Financial Institutions State Tax (FIST) Coalition to the Chairman of the Multistate Tax Commission (MTC) 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 FIST 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 included Citicorp, which now supports 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.

[6] OECD, *Addressing Base Erosion and Profit Shifting*, February 2013.

[7] OECD, *Action Plan on Base Erosion and Profit Shifting*, July 2013.

[8] For the changes in OECD permanent establishment rules under consideration, see: OECD, *Revised Discussion Draft, BEPS Action 7: Preventing the Artificial Avoidance of PE Status*, May 15, 2015.

[9] *Tyler Pipe* v. *Washington,* 1987. In *Tyler Pipe*, the Court held that hiring an independent representative in a state to solicit sales and conduct other activities that helped an out-of-state corporation create and maintain a market for its products was no different from having an employee in a state engaged in the same activities and did indeed establish BAT nexus for the out-of-state corporation. There was no suggestion in the case that the holding would have been any different if the in-state representative had solicited sales on behalf of more than one out-of-state company; indeed, the evidence strongly suggests that the representative did. The *Tyler Pipe* decision of the Washington State Supreme Court, which the U.S. Supreme Court reviewed, states that the Washington representative of Tyler Pipe was Ashe and Jones, Inc. of Seattle. Ashe and Jones was characterized by Tyler Pipe as an independent contractor, suggesting that it solicited Washington sales on behalf of multiple out-of-state businesses. Ashe and Jones appears to have been at that time a typical "manufacturers' representative" firm with multiple clients. The company certainly has multiple clients today, including Tyler Pipe. See: http://www.sdajnw.com/manufacturers/.

[10] Bradley W. Joondeph, "Are State Courts Biased Against Taxpayers that Seek the Protection of Federal Law?" *State Tax Notes*, October 27, 2003. Cases interpreting the application of P.L. 86-272 since this article was published include *Alcoa Building Products* v. *Mass. Commissioner of Revenue* (2003), *Asher* v. *N.J. Division of Taxation* (2005), *Inova Diagnostics, Inc.* v. *Texas Comptroller of Public Accounts* (2005), and *Skagen Designs, Ltd.* v. *Minn. Commissioner of Revenue* (2012).

[11] See, for example, footnotes 16 and 17 of the April 13, 2011 letter to the House Judiciary Committee Subcommittee on Commercial and Administrative Law in support of BATSA from the Coalition on Rational and Fair Taxation. Those footnotes identify 13 cases litigated since the *Quill* decision. There have been about ten additional cases not listed there in Louisiana, Oklahoma, Iowa, and Washington.

[12] See: *Wisconsin Dept. of Revenue*. v. *William Wrigley, Jr., Co.*, 1992. In 1972 the Supreme Court had heard a case on a very narrow issue involving the interaction between P. L. 86-272 and state regulation of the sale of alcohol.

[13] See the source cited in Note 1, p. 735.

[14] Bayer Corporation, General Electric, Johnson & Johnson, and Dick's Sporting Goods were members of the "CompetePA" coalition lobbying for the so-called "single sales factor apportionment" incentive in Pennsylvania. See: http://206.193.231.121/CompetePA/Members.asp. Johnson & Johnson and Walt Disney were members of the "Coalition for a Competitive California" lobbying for single sales factor legislation there. See "Report of Lobbying Coalition" for the first quarter of 2008, available at cal-access.ss.ca.gov/Misc/pdf.aspx?filingid=1326354&amendid=0. The latter two companies also funded the "No on 24" campaign in the fall of 2010 opposing a ballot measure that would have repealed California's single sales factor law. All five companies are listed as current members of the Coalition for Interstate Tax Fairness and Job Growth at www.interstatetaxfairness.com/who-we-are/.

[15] For a description of how this "intangible holding company" tax shelter operates, see p. 5 of CBPP's analysis of BATSA.

[16] Different versions of BATSA were first introduced in the second session of the 106th Congress in April 2000 as S. 2401 and H.R. 4267. Compare "Left unchecked, this expansion of the states' power to impose business activity taxes

will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation, and uncertainty escalate" (Testimony of Arthur R. Rosen before the Subcommittee on Commercial and Administrative Law of the Judiciary Committee in the U.S. House of Representatives, June 9, *2000*) to "Left unchecked, this attempted expansion of the states' taxing power will have a chilling effect on the entire economy as tax burdens, compliance costs, litigation, and uncertainty escalate." (Statement of Arthur R. Rosen before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary, United States House of Representatives, June 2, *2015*.)

[17] 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. H.R. 1956 was the version of BATSA introduced in the 109th Congress.

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

[19] Data on annual foreign direct investment flows into the United States are available at https://www.bea.gov/international/di1fdibal.htm. The first high-profile attempt by a state to enforce an "economic presence" nexus standard against a Delaware trademark holding company was the *South Carolina* v. *Geoffrey* case decided by the South Carolina Supreme Court in 1993.