FULL COMMITTEE HEARING ON BUSINESS ACTIVITY TAXES AND THEIR IMPACT ON SMALL BUSINESSES

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FULL COMMITTEE HEARING ON BUSINESS ACTIVITY TAXES AND THEIR IMPACT IN SMALL BUSINESSES

Thursday, February 14, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 11:30 a.m., in Room 2360 Rayburn House Office Building, Hon. Nydia Velázquez [chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Cuellar, Moore, Clarke, Higgins, Chabot, Akin, Davis, and Buchanan.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

Chairwoman VELÁZQUEZ. I now call this hearing to order on the business activity taxes and their impact on small businesses. In recent years, the American economy has changed dramatically, shifting away from the manufacture of goods to the delivery of services and intangibles. As a result, many states have sought to strengthen their eroding tax base by levying taxes on businesses that are not located within their jurisdiction. Today's hearing will focus on the potential problems many small businesses face when engaging in interstate commerce and the impact business activity taxes have on their firms.

As the name implies, business activity taxes, are just that: taxes imposed by a state for merely conducting business, rather than being physically located within a state's borders. While there are clearly circumstances when this is reasonable, the question becomes whether states are going too far.

This is not the first time this issue has come before Congress. In 1959, Congress enacted the federal interstate income tax law to address the matter of a state's ability to effect interstate commerce through taxation. Still in effect today, this law prohibits states from taxing the income of businesses whose only activities are the solicitation of orders for the sale of tangible personal property within that state. There is concern that this law needs to be clarified to prevent small firms from being unfairly burdened.

Typically business activity taxes are levied on corporate income generated within the taxing jurisdiction. However, some states have imposed a business and occupation tax based on gross sales. And others have imposed taxes in the form of fees or licenses for products sold within their borders. This means that a small busi-

ness software developer may be subject to licensing and use fees in states just for making sales via mail order.

If each state charged a $400 licensing fee to that small business owner, it is not hard to imagine the chilling effect this would have on a small company. Having to pay unpredictable taxes inhibits the growth potential for small businesses and our economy at large.

Congress is currently considering whether to provide clarity in this area by setting standards about when a state may invoke its taxing power. And for many small businesses, tax certainty is a primary concern.

Today's hearing will help provide perspective on the scope of the problem. The issue of the BAT is something that has gone under the radar but has an enormous effect on our economy.

The hearing will also provide insight on how any changes to federal law would affect a states' ability to tax legitimate economic activity. Limiting the ability of states is something that must be considered carefully.

Many of these revenues are used to provide vital services such as police, fire, and education, to their citizens. The witnesses here today will discuss how the BAT affects their industries.

As with most taxes, it impacts small and mid-sized companies to a greater extent than larger entities. Many small firms are completely unaware that they are even subject to these taxes until they receive a bill from a state taxing authority.

Smaller businesses also often lack the resources or capability to comply with the multitude of state and local tax laws that are triggered by business activity taxes. Further, the prospect of challenging an incorrect assessment is costly and time-consuming.

The issue becomes, how do we ensure clarity for these businesses while also ensuring that states are not going too far? While the issue is a complex one, it is important for thousands of businesses across this country.

I look forward to today's discussion. And I appreciate the witnesses coming here to discuss this important matter. I now will yield to the ranking member, Mr. Chabot, for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr. CHABOT. Thank you. Good morning, Madam Chairwoman. Thank you for holding this hearing examining one of the many tax burdens faced by small businesses. I'm looking forward to hearing from our distinguished panel of witnesses this morning. I know we all are.

There is no doubt that technological advancements have fundamentally changed the landscape for America's small businesses. No longer are small businesses confined to a regional customer base or disadvantaged by their inability to compete with larger companies because they lack the technological sophistication. In fact, advancements in technology have allowed small businesses to thrive in a global economy, now largely depend on global communications, just-in-time deliveries, and streamlined operations, all of which enable companies to decrease costs, increase capital investments, and provide new job opportunities.

Despite these efficiencies, technology has also brought uncertainty, particularly as it relates to the excessive tax burdens faced by our nation's small businesses. Benjamin Franklin once said that nothing in this world is certain but death and taxes. Well, as usual, Ben was right. And in this case, state revenue collectors are taxing America's small businesses to death through the business activity tax.

In 1959, Congress passed and President Eisenhower signed into law the Interstate Income Tax Act, which remains in effect today. This legislation prohibits states from imposing a tax on businesses whose only contact with a state involves solicitation of orders for tangible goods. Yet, nearly 50 years later, e-commerce and the Internet have greatly expanded the breadth of goods and services available to increasingly sophisticated consumers.

Unfortunately, these new avenues of commerce have also become favorite targets of overly eager tax assessors, who from state to state spin a tangled web of rules, regulations, and guidelines, guaranteeing countless headaches for American small business owners.

For example, some states believe that trucks nearly passing through the state only a couple of times a year without picking up or delivering goods even have sufficient connections with a state to justify imposing business activity taxes. Horror stories have surfaced describing state tax collectors' actually impounding trucks at weigh stations and demanding that companies pay unwarranted business activity taxes on the spot—simply for passing through the state.

While they're at it, perhaps the state tax collectors' offices should tax themselves for wasting taxpayers' money. It makes just about as much sense.

These accounts demonstrate the need for legislation that will lower the tax burden and provide greater clarity to small businesses trying to compete in an increasingly global marketplace.

Last week Congressman Boucher and Congressman Goodlatte introduced H.R. 5267, the Business Activity Tax Simplification Act of 2008. This legislation will go a long way toward accomplishing these objectives by establishing a physical presence nexus standard. It would eliminate the guesswork for small businesses in determining their tax liabilities by setting specific guidelines for states as they seek to tax businesses that actually conduct business within the state.

My home state of Ohio has the regrettable honor of being consistently ranked as one of the worst climates for small business in the entire country. This climate is largely determined by the state's propensity to tax: individual income taxes, sales taxes, unemployment insurance taxes, property taxes, goes on and on. Ohio has even begun to impose a gross receipts tax on businesses.

These excessive taxes are not the answer to turning the economy around in Ohio or anywhere else. Instead, we should be supporting legislation like the Business Activity Tax Simplification Act, which tells entrepreneurs and small business owners that it's okay to invest in our state or in other states around the country.

I thank Mr. Boucher and Mr. Goodlatte for introducing this important legislation. And, Madam Chairwoman, I commend you for

holding this important hearing today. And I look forward to hearing from our witnesses.

I yield back the balance of my time.

Chairwoman VELÁZQUEZ. Thank you. And now I yield to Ms. Moore for the purpose of introducing our first witness.

Mr. MOORE. Thank you so much, Madam Chair Velázquez and Ranking Member Chabot.

I am so very pleased today to introduce Mr. David Rolston, our first witness. Mr. Rolston is the President and CEO of Hatco Corporation, an employee-owned manufacturer of food equipment headquartered in Milwaukee, Wisconsin.

For the past 58 years, Hatco has been a company dedicated to exceptional customer service and quality engineered equipment. Hatco has consistently been a leader of innovative ideas for the food service industry, such as being the first to recognize the need to sanitize dish wear at 180 degrees Fahrenheit, food warmers for food security and food safety, while at the same time with their flavor saver devices so that it still tastes good after it has been sitting around. And, in fact, our own Longworth cafeteria uses Hatco equipment.

I am so proud to have Mr. Rolston here today representing my district. Mr. Rolston is here to testify on behalf of the North American Association of Food Equipment Manufacturers, of which Hatco is a member.

The North American Association of Food Equipment Manufacturers represents more than 600 firms which manufacture the equipment used for food preparation and service in the nation's restaurants, cafeterias, and other food service establishments. Most members of the Association are small businesses. Sixty-six percent, or two-thirds, of their members have fewer than 100 employees.

I so appreciate Mr. Rolston being here today to discuss the important issue of the business activity tax on small businesses. And, with that, Madam Chair, I yield back.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Rolston and all the witnesses, welcome. You have five minutes. In front of you, there is a timer with a green light. You start. And then the red light means that your time has expired.

STATEMENT OF DAVID ROLSTON, PRESIDENT, HATCO, ON BEHALF OF THE NORTH AMERICAN ASSOCIATION OF FOOD EQUIPMENT MANUFACTURERS

Mr. ROLSTON. Thank you for a very glowing introduction.

Mr. ROLSTON. Madam Chairman, Committee members, I am Dave Rolston, President and CEO of Hatco Corporation, a manufacturer of commercial food-warming, toasters, and water-heating equipment in Milwaukee, Wisconsin. We have 375 employees, all in Wisconsin. And the company is 100 percent employee-owned, or an ESOP.

I am also Chair of the Government Relations Committee of the North American Association of Food Equipment Manufacturers, for which I speak today. NAFEM represents more than 600 U.S. manufacturers, all in manufacturing commercial food preparation, cooking, storage, table service equipment, and supplies used in res-

taurants, cafeteria, institutional kitchens, and other commercial food service establishments.

Typical products are freezers, refrigerators, stoves, ovens, broilers, food warmers, table displays, and serving equipment, cutlery, virtually everything you would find in a commercial food service establishment. And I am proud to say that much of this equipment is still manufactured in the U.S.

This is a surprisingly large industry. Total domestic sales were over $8 billion. And it is an industry composed predominantly of small businesses. Sixty-six percent of our members have less than $10 million in sales per year and fewer than 100 employees.

We have members from 46 states of the union. Most, like Hatco, are single-state companies with no physical presence outside of their home states.

Efficiency and predictability are essential to a small business. The growing practice of states to assess business activity taxes on firms that have no physical presence in the taxiing jurisdiction has come as an unpleasant and shocking surprise. If left unchecked, these taxes will become a nightmare for small businesses, increasing our administrative costs, adding an unnecessary layer of inefficiency, and limiting our ability to grow.

Let me give you our example. Hatco, like most NAFEM members, sells through independent manufacturer's representatives who represent 10 to 15 different companies. Hatco also uses independent service agents to complete warranty repairs on our equipment. Again, these independent companies service the equipment of many different manufacturers.

Neither of these companies causes Hatco to have any physical presence in any state outside of Wisconsin. Nonetheless, we are now being forced to pay business activity taxes in four states where we have customers but no physical presence.

Justification given by these states for these taxes is the existence of the representatives and/or the state service agents. Of course, our manufacturer's representatives and service agents in these states do pay income taxes on their own business profits. This is as it should be. We should be paying taxes in states where we have presence and receive government services. For us, that is Wisconsin. We should not be paying business activity taxes, which are a form of income tax, where we have no physical presence.

We don't know what other states will come at us next. These tax bills catch us by surprise. When states first contact us, they sometimes come on hard. One state originally demanded that we pay eight years of back taxes. This would have been significant. Others have threatened penalties.

Litigation, of course, is impractical for a small firm. We try to negotiate, and then we pay up. We can't pass the costs on. So both the tax payments and, even worse, the administrative costs come off our bottom line.

What are the consequences? Think about where this is going. Facing business activity taxes assessed by four states where we have no presence is bad enough, but consider 20, 30, or even all states assessing these taxes. We would have to add significant staff in an attempt to keep track of all of these unforeseeable obligations, file the returns, and stay clear of all penalties and demands

for back taxes. These would, of course, be unproductive employees, a hit to our efficiency.

Bear in mind that we are a 100 percent employee-owned company. So any additional costs affect our employees directly. And what about the overall impact to the economy? The taxes we pay to states where we have no physical presence comes off our net profits. So do the administrative costs, which are an even larger burden.

As our net income after expenses is reduced, the taxes we owe to Wisconsin are reduced. After you factor in both the added taxes and the added administrative costs, both to us and the states, I doubt that anyone is coming out ahead on what the economists would call a macroeconomic level. Certainly if other states jump on this bandwagon, we will just be spreading the taxes around with little or any net benefit to anyone.

As a small manufacturer in the U.S., we face many threats from competitors outside our borders. We continue to be successful by staying lean and smart. Adding unnecessary head counts to administer programs like activity taxes makes us less competitive, not only here but overseas.

For many years, it has been the presumption that businesses pay taxes only in the states where they have physical presence and receive government services. We believe that Congress should act to preserve this standard.

Thank you.

[The prepared statement of Mr. Rolston may be found in the Appendix on page 30.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Rolston.

Our next witness is Mr. Barry Godwin, who is the Controller of Stingray Boat Company. Stingray Boat Company is located in Hartsville, South Carolina and has been in business since 1979 and employs 240 people.

Mr. Godwin is testifying on behalf of the National Marine Manufacturers Association. The association represents 1,400 companies that produce products used by recreational boaters.

Thank you for being here and welcome.

STATEMENT OF J. BARRY GODWIN, CONTROLLER, STINGRAY BOAT COMPANY, ON BEHALF OF THE NATIONAL MARINE MANUFACTURERS ASSOCIATION

Mr. GODWIN. Madam Chairman and members of the Committee, thank you for inviting me to express my views concerning the business activities tax, the tax burdens felt by small businesses engaged in interstate commerce, and the issues it addresses.

I am the Controller at Stingray Boat Company. Like most small business managers, I have multiple responsibilities and perform various tasks.

Stingray Boat Company was founded by Al Fink in 1979, where Al remains the president of the company. Al Fink remains keenly involved in the company, from its roots to the top. Stingray Boats, located in Hartsville, South Carolina, employs 240 individuals full-time.

We are, by all standards, the epitome of the American dream and a small business proudly dedicated to our employees and their families. Stingray builds fiberglass boats from 18 to 25 feet in length. We ship to almost every state within the U.S., Canada, Europe, and Australia.

In my testimony, I will relate three differing experiences that I had with three different states. I am seeking clarification of P.L. 86-272, as each state is interpreting how tax nexus has occurred between us and them.

The burden placed upon Stingray is to incur legal fees, accounting fees and time to address each state as they seek to attach an economic nexus to Stingray'S business activities. This is another tax in addition to the sales tax incurred by the independent dealer in the jurisdiction of that state.

Until three years ago, we were unaware of nexus implications as it relates to taxes. In 2005, we began to hear more about nexus. We became aware of a situation in which the State of New Jersey had stopped another boat manufacturer's boat load due to nexus issues. We researched what nexus meant to us. Our activities within all states are the same.

We operate according to P.L. 86-272. Our boats are sold to independent dealers. All orders are taken within the State of South Carolina via the telephone or Internet. Boats are paid for before their delivery is taken by the dealer.

Sales representatives from Stingray may travel to see a dealer from time to time but do not operate a Stingray office within that state. Dealers visit Stingray each year to review new products and test drive the boats. The boats may be delivered to the dealer on our trucks or by a contract carrier. We reimburse the dealer for warranty work performed by them on our boats. We believe we are operating within the law.

The State of Maine versus Stingray, in 2006, a revenue agent from the State of Maine sent a letter to us regarding our actions with that state. I responded to Mr. Flynn, representing the State of Maine, that we believed that we were operating within the confines of the law. After I had completed a nexus questionnaire, Mr. Flynn told us that we had created a nexus by paying the independent dealer for warranty work performed on one of our boats.

I assume that the dealer paid tax to Maine on the amounts received from us as payment for the work done in Maine. Stingray did not perform the work, but because we had paid the dealer, Maine claimed that our action created a nexus.

I objected to the revenue agent, but we decided it would be less costly to pay the retroactive taxes and fines than to pursue the matter in the courts. The State of Maine agreed to require us to file tax returns and payments covering the years 2003 through 2005 and to abate any penalties during this period.

The State of New Jersey versus Stingray, on July the 23rd, 2007, I received a call transferred over from our truck fleet dispatcher at 10:15. The person on the other end was Ms. Kostak, a revenue agent from the State of New Jersey. I was immediately told that our truck had been pulled over at the weigh station on the interstate highway and could not move until we paid New Jersey for jeopardy assessment taxes.

I asked Ms. Kostak why they were doing this. I was told that we had a dealer in the State of New Jersey. This incident was becoming unbelievable. So I asked her to fax me proof that she was who she said she was.

I asked what I could do to let the driver go, and I was told to pay the New Jersey Division of Revenue money. I asked how much, and I was told it depended upon our sales into the State of New Jersey.

I looked up the sales for the past seven years as requested, and Ms. Kostak quoted me a price of $46,200 to release the truck. I then told her I would need to discuss the issue with our company president.

Ms. Kostak told me I had until 1:00 p.m. that day to get them the money or the truck would be impounded and we would need to make arrangements to retrieve the driver. I asked her, "Can I not send you a check or work something out to let the truck pass through New Jersey?" I was told to wire them the money.

I first talked to the truck driver and asked him what had happened. Our driver was passing through the State of New Jersey carrying a load of boats for delivery into Massachusetts. Our driver told me that the agent pulled his rig over at the weigh station and asked him if we had a boat dealer in New Jersey. The driver had never delivered into New Jersey and told the agent, Ms. Kostak, that he did not know.

Because he did not know whether we have a New Jersey dealer, he gave Ms. Kostak our home office number and the dispatcher's name. Ms. Kostak called our dispatcher and found out we had a dealer in New Jersey, and more probing questions were asked and then passed over to me.

After talking to Ms. Kostak, I discussed the situation with our company president. He decided to call another boat manufacturer that this had happened to. In summing this up, Madam Chairman, I felt that we were the victim of extortion by the State of New Jersey. And the only way that we could let our boats pass through to Massachusetts was to pay the fees before they were turned free.

And I ask that the Committee please consider clarification of 86-272. It is very important to us, a small business. And I appreciate your time.

[The prepared statement of Mr. Godwin may be found in the Appendix on page 32.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Godwin.

Our next witness, Mr. Steven Joost, is the Chief Financial Officer for Firehouse Subs, headquartered in Jacksonville, Florida. Firehouse Subs has been in business for 13 years and operates over 300 restaurants across 14 states.

Mr. Joost is testifying on behalf of the International Franchise Association. IFA represents franchisors, franchisees, and suppliers throughout the world.

Welcome, sir. You have five minutes.

STATEMENT OF STEVEN JOOST, FIREHOUSE SUBS, ON BEHALF OF THE INTERNATIONAL FRANCHISE ASSOCIATION

Mr. JOOST. Thank you.

Mr. JOOST. Thank you, members of Congress, ladies and gentlemen, for allowing me to testify before your Committee today. Again, my name is Steven Joost. I am the Chief Financial Officer and principal in Firehouse Subs. I am also a Florida C.P.A. and a member of the city council in Jacksonville, Florida.

We have 312 restaurants operating from Las Vegas, Nevada to right here in Washington, D.C. We started in Jacksonville, Florida 13 years ago. Through our franchising efforts we employ over 5,000 people and have achieved the national sales level of over $200 million. Firehouse has helped numerous employees, franchisees, and area representatives achieve their American dream. And yes, some have become very wealthy.

On the national level, franchising also has made a tremendous impact on the economy and the entrepreneurial spirit of Americans. According to a 2008 International Franchise Association Educational Foundation study conducted by PricewaterhouseCoopers, there are over 900,000 franchised businesses currently operating in the United States, employing over 21 million workers. This is responsible for $2.3 trillion in annual economic output.

During that time, over the last 13 years, we have come across various impediments to our growth. There are the usual ones: products, competing for real estate, competing for employees. These are all natural impediments that every business competes for. And we work very hard to outwork our competitors.

However, there have been many artificial barriers, complexities, and tax traps that have been created by government that have hurt my business over the years that have led to unwarranted expenses and wasted money. I am here today to help explain what myself and my company have been through and to add suggestions as to how you may be able to help.

One of the more perplexing problems facing a growing business is that of interstate commerce. Of course, as you are well-aware, with our federal system of government, each state is allowed to make its own laws. This has led to the implementation of many different laws with many different standards.

Examples are differing disclosure requirements for our disclosure documents, differing sales tax methods and rates, differing income tax laws and application thereof, just to name just a few. These differing laws and standards upon which they are applied have necessitated my company to hire a plethora of tax accountants and lawyers to help us comply with the regulations, file the various tax returns and documents that each state requires. We have to employ various strategies to help limit our liabilities. And sometimes, quite frankly, I wonder what business I am in.

One of the more disturbing problems created by governments is that of state income taxes and franchise taxes. As economic growth has slowed, so has state revenue growth. According to Allison Grinnell of the Rockefeller Institute, when adjusted for inflation, state revenue actually dropped .6 of a percent. So, therefore, the squeeze is on for the states to find more money to help them fund their budgets.

One of the ways they do this is through nexus. Very simply, nexus is a connection. It means connection. Certain activities, as insignificant as they may seem, may establish a nexus.

A company may have unknowingly had nexus with a state for many years. It might even be responsible for back sales tax, franchise tax and/or income taxes, penalty and interest for past years.

Examples of creating nexus that an ordinary person would never think of are having a sales representative just solicit business, traveling for a meeting within a state, traveling to inspect a store, or even the mere just asking for somebody for their business in a state can trigger nexus. It depends which state you're in and which 50 rule is being applied to you.

And then, worse yet, the nexus standards between states vary widely and wildly. Furthermore, the nexus standards within a state within different years can change depending on who the latest administration comes in and who is interpreting the law.

For example the nexus standards for franchise taxes are much broader than they are for income taxes. This means a company that could be exempt from paying income taxes in a certain state and think they're home free, all of a sudden, gets a bill for paying a franchise tax liability if they do business in that state depending on how nexus is defined.

Each state has its own department of revenue and interpretations on how the laws are applied change. Once a nexus is established, then the states get into the game of apportionment. Apportionment is the formula to figure out how much income is attributable to a specific state's income tax. Apportionment rules are often changed by the individual states to help them garner advantage over other states.

Currently, my view on the subject matter is the way states are imposing burdensome rules and changing them every year is an unfair tax on intellectual property rights. And, secondly, it has created a subsidy for lawyers and accountants.

I believe the fact that the whole Firehouse concept was created in Jacksonville, Florida—okay? And in its very essence, royalty is paid for our trademarks and the fact that our property is in Jacksonville. I helped create it. I spent 13 years creating it. You know, our business model, our trademarks, our marketing all is created in Jacksonville. And, in essence, a royalty is rent for these trademarks.

So if I own a piece of property in Jacksonville, Florida, why, in essence, am I paying property taxes in all of these other states? It's beyond me.

So I believe these rules have created an unintended attack on the franchise business. While I am not and my company is not opposed to paying taxes, what we are opposed to is spending hundreds of thousands of dollars to figure out how to do it because we have to hire an army of accountants and lawyers to do so.

What is needed and what I would recommend is either to get rid of nexus or at least apply a single set of rules defining what constitutes nexus and how it will be applied in a uniform manner in all 50 states so when I go into a mine field I at least know where the mines are.

Chairwoman VELÁZQUEZ. Mr. Joost, your time is up.

Mr. JOOST. Okay.

Chairwoman VELÁZQUEZ. Okay? So during the question and answer period, you will be able to expand on how you feel we can—

Mr. JOOST. Thank you for hearing me out today. I appreciate it.

[The prepared statement of Mr. Joost may be found in the Appendix on page 42.]

Chairwoman VELÁZQUEZ. —clarify this issue. And thank you very much for your testimony.

Our next witness is Mr. Michael Petricone. He is the Senior Vice President of Government Affairs at the Consumer Electronics Association. Mr. Petricone is responsible for developing and implementing the public policy priorities.

CEA is a frequent public speaker on issues impacting the consumer electronics industry. CEA represents more than 1,000 U.S. manufacturers of audio, video accessories, mobile electronics, communication information, and multimedia products that are sold through consumer channels.

Welcome, sir.

STATEMENT OF MICHAEL PETRICONE, SENIOR VICE PRESIDENT, GOVERNMENT AFFAIRS, CONSUMER ELECTRONICS ASSOCIATION

Mr. PETRICONE. Good morning, Madam Chairman and Committee members. Many of you know the Consumer Electronics Association as the representative of America's most innovative companies, but the fact is 80 percent of our members are small businesses. In reality, CEA is a small business association.

Also, I grew up in a small business family. So I am delighted to be here talking about this issue.

No taxation without representation is America's first governing principle. Having established our nation under that cry, our founders went further. They created a single national economy and imposed constitutional safeguards to ensure that the states cannot impede interstate commerce.

Unfortunately, the system our founders put in place is eroding. As you heard today, about a dozen state and local governments are imposing income taxes on businesses with no physical presence in the taxing state. The states have adopted a variety of ill-defined so-called economic nexus theories to justify these levies.

The problems caused by this growing patchwork of taxation are obvious. And they fall disproportionately on our members. This Committee knows that small businesses run close to the bone. To thrive, they need reasonable taxation and a settled, predictable business climate, but increasingly they face significant costs of determining their state tax liabilities. They must meet multiple filing requirements, keep multiple records, and deal with multiple sets of regulators. And it is becoming difficult for them to make any reasonable estimate of their projected tax burden. You can imagine the challenges of long-term business planning in such an environment.

Of course, small firms also have few resources that challenge questionable assessments in faraway states. As a practical matter, when faced with these levies, many of our members have little choice but to bite the bullet and write the check. As a technology association, we are especially concerned with the burdens the situation places on electronic commerce.

At the very moment that the Internet grants every small business access to a national marketplace, a crazy quilt of local tax obligations throws a roadblock across the electronic highway. Small businesses will avoid sales to the various states. And consumers, especially those in remote areas, will be unable to go online and get the goods they need, This situation will not resolve itself. In fact, it will likely get worse.

Our-of-state businesses present tempting targets to legislators trying to raise revenue. Naturally states have every political incentive to export their tax burdens as aggressively as possible.

Meanwhile, state courts have made conflicting decisions. And the Supreme Court has declined to address this issue. The Supreme Court recently refused to hear two cases challenging the constitutionality of the economic nexus approach. States see the Supreme Court decision or of non-decision as a green light to press forward with more economic nexus legislation.

Pursuant to your authority under the commerce clause, it is time for you to act. There is ample precedent here. A few examples. You have moved to prevent multiple state taxes on electronic commerce. You have ensured that states cannot impose fly-over taxes on airlines. And you have restricted taxation of mobile communication services by the state where the service is primarily used.

Specifically, we urge you to support H.R. 5267, the Business Activity Tax Simplification Act. This bill provides that pursuant to the commerce clause, a state may not impose business activity taxes on a business that has no physical presence in the state. It contains protections to ensure that businesses cannot restructure their activities to avoid paying legitimate taxes.

This bill's physical presence will instantly clarify as the state taxation landscape. It is easy to understand. It is easy to enforce. Its bright line standard ensures that small businesses know with certainty when and where they will be taxed. For an owner, this means fewer resources spent on tax compliance litigation and more invested in building her business.

Such an approach would also ensure compliance with our international treaty obligations. In every tax treaty to which the U.S. is a party, the universal requirement for imposing income taxes on non-residents is a physical presence in the taxing jurisdiction.

Our members are good corporate citizens. We do not object to paying our fair share of taxes. We simply believe that the states that provide meaningful benefits to a business, water, roads, fire, police protection, should properly receive a state's business taxes, rather than a distant state that provides no benefit.

The Constitution is clear. The right to regulate beyond individual states' borders lies not with the states but with Congress. A bright line physical presence eliminates ambiguity, stimulates investment, and promotes interstate commerce. It is good for small business. It is good for the economy.

We urge Congress to support H.R. 5267, the Business Activity Tax Simplification Act. Madam Chairman and members of the Committee, I commend you for holding this hearing, and I look forward to answering your questions.

[The prepared statement of Mr. Petricone may be found in the Appendix on page 46.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Petricone.

Our next witness, Dr. Peter A. Johnson, is a senior economist and Vice President for Research Strategy and Platforms with the Direct Marketing Association. At the DMA, Dr. Johnson's research focuses on economic and policy issues pertaining to direct and interactive marketing.

The Direct Marketing Association is the leading global trade association of businesses and nonprofit organizations using and supporting multi-channel direct marketing tools and techniques.

Welcome, sir.

Mr. JOHNSON. Thank you, Madam Chairman. Thank you, ranking member. And thank you, other members of the Committee.

STATEMENT OF PETER A. JOHNSON, Ph.D., VICE PRESIDENT/ SENIOR ECONOMIST, DIRECT MARKETING ASSOCIATION

Mr. JOHNSON. On behalf of the Direct Marketing Association, it is my pleasure to be here and making my inaugural appearance before any congressional committee.

It is and has been the longstanding position of the Direct Marketing Association and its members that a clear physical presence test, such as found in the current legislation and its predecessors, is consistent with the Constitution and the overall stricture of our federal system.

My colleagues George Isaacson and Mark Micali, who is with me here today, have spoken before this House Committee, these various House committees, to this effect emphasizing the legal perspective.

What I hope to do is to bring the economist newspaper because in a sense, my association represents everybody along this table. Direct marketing is not any one particular industry. Direct marketing is basically a way of bringing end-users and primary sellers together.

There have always been two kinds of marketing across the states. In fact, anybody who checks their pantry in their kitchen knows that almost everything in the household or on a business today at some point crosses state boundaries. The question is how.

What I want to propose to you today, members of the Committee, is an essentially economic framework within which I believe you should understand not only the current version of the bill but what happens as it goes through your various future deliberations because I think that the route here is fundamental misunderstanding of what is involved in the latest form of interstate commerce.

Essentially what is going on here is that there have always been two kinds of interstate commerce, one that's focused on mass marketing. And you all know mostly what it looks like. It's big physical structures, like, you know, the big box retailers or your local branch or store.

Mass marketing worked across interstate boundaries because there were efficiencies of scale that allowed bringing bulk products to big, bulky markets and concentrated areas.

But although it wasn't often seen during the heyday of broadcast television and radio, there was always another kind of marketing that crossed state boundaries. And that was direct marketing or

what is now often called interactive marketing. It was originally the post office set up by Ben Franklin.

And what is different about this is that it uses economies of scope to bring not the product to the customer but fundamentally to bring the customer to the seller or the product.

Now, it may not be apparent that this is what is going on. But for anyone who has really thought about what is at stake at the Internet, that is really what is occurring is that in investing in information, whether it was direct mail solicitations and the statistics that underlie that—and I explain this in probably lugubrious detail in my written testimony—or it's now the Internet and investment in search ads.

The basic logic is, bring the customer to the seller or the product, as opposed to bringing the sell or the product to the end customer. Why does this matter for business activity? For all of the different industries and different kinds of products and services available through my members and so on and everybody here.

Essentially there are much lower start-up costs and much lower overhead investments that make this kind of marketing unusually attractive to small businesses. And business activity taxes discriminate against this way of bringing the end customer to the primary seller in a way that I don't think the states really fully understand the underlying logic.

To put it most simply, at the end of the day—and this is going to sound like a paradox. I would be happy to offer a pedantic statistics tutorial to explain why this is. In direct or interactive marketing, the smaller the business, the more likely it is that their end customers will be disbursed across multiple jurisdictions. In mass marketing, the more likely it is, the smaller the business or the more concentrated or, in other words, the fewer the jurisdictions to which they will be exposed.

Now, our state/federal tax system was set up on the assumption that almost all interstate commerce fell along the lines of mass marketing. Now, because of the increased efficiencies of statistical analysis and the Internet itself, transacting across boundaries by bringing the customer to the primary seller is making, a, the small business opportunity increasingly valuable to the small business so that we see in retail, non-store retail, for example, the number of small firms has increased far faster than the number of large firms.

In fact, the number of large traditional store retailers has been decreasing over the Internet decade while the number of non-store retailers has been increasing dramatically, the efficiency has been increasing dramatically. The bottom line is—and that is just retail—it's similar. Is it manufacturing, finance, insurance?

This way of bringing customers to the primary seller, using interstate carriers and interstate communications media, which are not directly owned by the customer or the seller, offer unusually low barriers to entry and increased inefficiencies in terms of promoting overall growth.

Thus, given the fact that for statistical and financial investment reasons the smaller the company the more jurisdictions, the business activity tax levied potentially across all 50 states and all of the thousands of sub-state jurisdictions to which a small business

who is marketing directly is exposed, obviously inherently the more exposed they are to this tax and the resulting burdens.

The bottom line, as I said, is, unlike other forms of marketing, the basic fundamental logic requires small businesses to run this risk to incur more exposure to more state and sub-state jurisdictions.

We looked at what is currently being lost as a result—

Chairwoman VELÁZQUEZ. Dr. Johnson, the time is up.

Mr. JOHNSON. All right.

Chairwoman VELÁZQUEZ. We will continue having this conversation—

Mr. JOHNSON. Thank you, Madam Chairman.

[prepared statement of Mr. Johnson may be found in the Appendix on page 50.]

Chairwoman VELÁZQUEZ. —in the question and answer period. Thank you.

Mr. Joost, I would like to address my first question to you.

Mr. JOOST. Sure.

Chairwoman VELÁZQUEZ. You mentioned that certain states have been especially aggressive in attempting to collect business activity taxes from your firm. Have you scaled back operations in these states? And how has this affected the economics of your business?

Mr. JOOST. To answer your first question, yes. Specifically I'm not trying to point fingers, but the State of South Carolina comes to mind. Just the fact that we have stepped foot in that state creates what they call a nexus. And now they want part of our income tax, state income tax.

While it has not scaled back our activity per se, it does cost us money and, therefore, lowers our profit margins. At the end of the day, you just look at it. And it's the cost of doing business.

And what happens, what we have done in our company since we started our company 13 years ago, we did not take a dividend for ten years. We put every dollar and dime we made back into our business.

So theoretically answering your question because now we don't have as much money to put back into our business and grow it, that effect, yes, has stopped/slowed growth.

Chairwoman VELÁZQUEZ. Do you believe it is possible to establish a clear standard that would allow businesses to know that if they do X, Y, or Z in a state, that that will be subject to that state's taxing regime?

Mr. JOOST. Absolutely. And I think the Committee right here is going to do it.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Petricone, those in favor of business activity taxes argue that these taxes broaden the tax base and allow for lower taxes for locally owned businesses. What is your reaction to the criticism that a clear jurisdictional standard will limit the tax base to only those in state companies? How would you respond to those who argued that this could lead to higher taxes for local small businesses?

Mr. PETRICONE. Thank you, Madam Chairman.

First of all, I would take issue with any notion that this approach would lead to an aggregate lowering of taxes on businesses

because the businesses will still be paying the taxes in the state where they are domiciled.

Beyond that, I think certainly there in any way range of factors that affects any given state's tax revenues at any given time. But I do keep coming back to what I believe is a basic principle of fairness that if a company is not domiciled in a state and does not have a presence in that state, that state should not be subject to the state's taxes.

And some of the stories you hear from Mr. Godwin, for example, of trucks being seized as they go across state borders I think are exactly the sorts of situations envisioned by the founders when they drafted the commerce clause.

Chairwoman VELÁZQUEZ. Mr. Godwin, you mentioned that you canceled your membership with the Northwest Marine Trade Association to prevent any potential nexus with the State of Washington. And you also stated that Maine asserted a nexus was established due to the fact that you paid an independent service dealer to perform warranty work on one of your boats.

Is it possible for you to take the same approach you did with the State of Washington to prevent any nexus or does your business model require this type of relationship with local service dealers?

Mr. GODWIN. Madam Chairman, every independent dealer we do ask them to service the boats if there is a problem that needs to be corrected and a consumer brings it in. And we reimburse them for their work that they do.

So we operate the same way in every state. And our business model does require that we do that. It's basically the way the industry works.

Chairwoman VELÁZQUEZ. Mr. Rolston, you stated that one of the greatest challenges for small businesses is that they are completely unaware that they are even subject to these taxes. Many only find out after they receive a tax bill from a state. Can you discuss your experience when you receive a notice or notices about potential business activity, tax liability? And was there any documentation as to what type of activity on your part triggered taxation?

Mr. ROLSTON. Yes. We are currently paying taxes in Michigan, Washington State, Iowa, and Ohio. And in every case, they cited either the presence of an independent manufacturer's rep, who represents our equipment and those of many other companies—so they are independent business people—and/or the independent service agents. Much as the boat dealer situation we have service agents that are separate from our dealers, but they are service agents who service the equipment on our behalf. They service many other people's equipment also. So yes, in both cases, it was the presence of an independent businessman.

Chairwoman VELÁZQUEZ. Okay. Thank you.

Dr. Johnson, in the past, the issue of business activity taxes has mostly been a concern for large corporations doing businesses across the country. However, we have seen some dramatic changes to our economy shifting away from one focused on manufacturing to a more service-based economy.

Given that dynamic, why are business activity taxes now more of a problem or issue for small businesses than in the past?

Mr. JOHNSON. Well, thank you.

You are absolutely right about why are they more, because essentially on both the end seller side and the middle men; that is to say, the firms that create economic passageway connections between end sellers and markets, both of those are affected by business activity taxes. And, unfortunately, both the end sellers and the intermediaries, whether it be the common carriers or the communication networks, have particularly low barriers to entries for small firms.

And so given that interactive marketing, direct marketing, is drawing more and more business activity, business overall is growing faster in this area and the firms are getting smaller, the net balance now as states introduce more business activity taxes is falling increasingly on the small firms who are wanting to use these indirect connections to bring customers to them.

Chairwoman VELÁZQUEZ. Thank you.

Now I recognize Mr. Chabot.

Mr. CHABOT. Thank you very much, Madam Chair.

I think you described the onslaught that you faced in many of these examples that you had when the states were coming after you.

I think, Mr. Rolston, you said you negotiated but then ultimately paid up. Mr. Godwin, I think you referred to it as extortion, which was the word that I had floating around in my head when you were describing your situation.

It was either you, Mr. Joost, or Mr. Petricone. I'm not sure. One of you said you ultimately bit the bullet and cut the check. I guess that was you.

The three of you, could you describe what sort of thought process went on, the conclusion that you ultimately reached when you came to the decision that you had to surrender and pay, even though I think to your core you felt this was not a fair situation that you were facing? And maybe I'll begin with you, Mr. Rolston, if that's okay.

Mr. ROLSTON. Well, it is like a lot of situations where you are faced with a potential litigation. You choose which is more or least expensive. In this case, specifically they wanted the eight years' payment in the past. We were able to negotiate that down to a more reasonable number, something that we considered acceptable. And then we paid it, as opposed to litigating, because litigating would have been much more expensive and, from what I understand, not very successful.

So in each case, that was our situation. It came down to a strictly economic decision.

Mr. CHABOT. Mr. Godwin?

Mr. GODWIN. For us, New Jersey, we didn't have a choice. Our boats were stranded on the interstate. And the only way they could get to the dealership in Massachusetts was for us to wire the money to the State of New Jersey within this time frame they specified. And if we didn't do that, our boats were being impounded and we were told that it was left up to us to take care of our driver. So I didn't have a choice. I mean, it was "Show me the money, and we'll let you go or you're stuck."

But, then, during that time frame, we also talked to a fellow boat-builder who had been through a similar situation. They had

incurred over $100,000 in legal fees. And so we decided that we would rather go ahead, pay this, and deal with the New Jersey tax courts possibly at a later time and file the tax returns as they requested so that we could in the future also continue to ship boats through their state because we were told that if we didn't do what they were asking, the next time we showed up through the state, that we would be going through the same situation.

Mr. CHABOT. I will yield.

Chairwoman VELÁZQUEZ. Will you yield?

Mr. CHABOT. Yes.

Chairwoman VELÁZQUEZ. Mr. Godwin, have you been forced to curtail operations?

Mr. GODWIN. We haven't yet. We are basically taking this as each state comes at us and dealing with that situation. It's just this particular situation, we didn't have a lot of time to react or deal with it in a business manner.

Chairwoman VELÁZQUEZ. Thank you.

Mr. CHABOT. Reclaiming my time, Mr. Petricone?

Mr. PETRICONE. Thank you.

In my position, I regularly get anguished calls from members who received a significant tax bill they didn't expect and don't understand. Often the state approach is very aggressive, involving threats of seizure of inventory, you know, back taxes going back multiple years.

As far as the advice I give them, it is not very helpful. I ask them if they have the resources to devote to litigating and contesting the issue. For the vast majority of small businesses, the answer is clearly no, in which case I advise them to comply.

What makes it worse is there is a Pandora's box effect, where if a big business complies in one case, they soon find other states coming after them. So, unfortunately, there are no good answers.

Mr. CHABOT. Thank you.

Mr. Joost, obviously you are trying to grow your business to the extent you are able to. What impact does this have on a business owner like yourself who is trying to grow businesses and, most importantly, create jobs, which is obviously important to the overall economy?

Mr. JOOST. Thank you for asking that question.

Going back to the Madam Chairwoman's question, while you can't say there is necessarily a direct correlation because you have incurred these higher costs, intuitively you know there is an opportunity cost.

Like for my company, for example, going back to the fact that we did not pay dividends for the first ten years of our existence, we constantly put the money back in our company, growing company stores, hiring people to build the foundation so we could start our franchising operation.

So, just intuitively, if you know the fact that you don't have as much money to reinvest in your company, you can't go out and hire more people. You can't go out and get more franchisees. And you can't go out and create more jobs. So there are opportunity costs there. Whenever you impose higher costs on these companies, the opportunity is gone to invest that money to create more jobs and create an economic multiplier.

Mr. CHABOT. Thank you.

Dr. Johnson, those states that are most aggressive in pursuing these types of taxes, do you have an opinion as to whether the ultimate business activity in that state would, in all likelihood, be suppressed in some manner? In other words, those states that are taxing higher, do businesses take their business elsewhere or avoid those states, if possible? Any comments that you would have on that?

Mr. JOHNSON. I do. I think that cumulatively—and I emphasize cumulatively—as one of my colleagues said, the Pandora's box effect is that, in fact, you get—to draw a different analogy, a kind of tragedy of the commons, similar to where in medieval England, there would be a town with a central pasture that all of the local farmers would graze their sheep on. Well, the first farmer to graze the sheep on that pasture, his sleep flourished. But by the time the 50th sheep farmer shows up with his sheep, the pasture is completely denuded.

So yes, I believe that as more and more states become aggressive, the cumulative effect will be negative. And, in fact, let me tell you that I believe because the tax falls both on the small business intermediaries and the small business marketers who use those intermediaries, we did some preliminary calculations.

Our estimate is that there are approximately $755 million, at least, of sales to these small businesses, who are the intermediaries that are being lost across the states that are doing this and that the opportunity cost, the lost revenue, amounts to about $8.9 billion, or 44,000 jobs, across the economy as a result of the states doing this.

Mr. CHABOT. Could you repeat that one more time, the numbers?

Mr. JOHNSON. Sure. So assuming that the CBO is essentially correct in some earlier versions of this bill in adjusting downward for the new version of the bill that's currently before your Committee, we estimate that there are some $755 million that are not currently being spent on the small business intermediaries who are helping to bring customers to original sellers and that the opportunity cost; in other words, the lost sales that marketers are not receiving from those customers as a result, amounts nationwide to $8.9 billion, which if that $8.9 billion could be restored in 2008 to the American economy through the passage of this, the physical presence test, de minimis provisions, would result incrementally in 44,000 jobs. That's 44,000 jobs that BAT taxes we believe are currently preventing the U.S. economy from producing.

Mr. CHABOT. Thank you very much. I yield back the balance of my time.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Petricone, the legislation being considered will clarify physical presence as the standard for establishing nexus as the basis for taxation. Using this nexus test, would it be possible for the company to have employees in a state and solicit sales from residents in the state yet not be subject to any business activity taxes?

Mr. PETRICONE. Madam Chairwoman, we believe not. And we believe that the existing legislation, BATSA, is put together in such a way as to prevent companies from gaining system, in effect. It is a 14-day period. And after the 14 days, you are considered to

have a nexus in the state. So we think that is a bright line and easy to understand and easy to enforce.

Chairwoman VELÁZQUEZ. Okay. Mr. Akin, let me ask just one more question. I didn't see you. I'm sorry.

How would you respond to critics who suggest that this standard may deny states the right to tax businesses that are using the services of that state? Mr. Petricone?

Mr. PETRICONE. Right. The state will still be able to tax the in-state. To the extent there is an in-state representative that is domiciled in that state, then they will still be susceptible to taxes. If there is somebody in state A who is manufacturing a machine and then that machine is sent to state B and sold by somebody in state B, then the seller in state B will be taxable by state B. And included in the tax will be the value of the machine made in state A.

So, again, the aggregate pie remains the same. And then the state gets the benefit.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Akin?

Mr. AKIN. Thank you, Madam Chair.

This is my eighth year of being here. And I have sat in some very, very interesting Committee hearings. But I have never sat in a Committee hearing on highway robbery before. And so I would really like to compliment you on your choice of a topic. I mean, this is really something new and innovative.

I don't know if any of you are really trained in terms of monetary theory, but my sense is that we just passed a thing called an economic stimulus package. I don't know how much stimulating it is really going to do but maybe some small amount.

If I were going to choose an economic stimulus package, I would think stamping this practice out would be at the head of my list just in terms of common sense because the place where we really get the economy going is small business because they can react rapidly and they can invest in different equipment or procedures, which allow companies to grow and create a lot of jobs.

It seems like this is a tremendously destructive practice. And if one state starts it and it starts cascading—I don't know if anybody wants to comment on that.

As I said, I haven't ever sat in a Committee on highway robbery. Thank you, Madam Chairwoman, for this wonderful and interesting twist of things, the dumb things that government can do.

Mr. ROLSTON. Yes. I will comment. I mean, that is the primary reason I am here. Right now the four states that we're paying to are a burden, but it's not a huge burden. My fear is that when it gets to 50 states, that it will be a huge burden and we will have 5 or 6 people on our staff just to deal with the technicalities.

Mr. JOOST. I would also like to comment. I am not so much against the taxes. It is literally we have paid accountants and lawyers hundreds of thousands of dollars to figure out how to comply with the laws. I don't mind paying taxes. I just hate paying an army of people to figure out how to do it. If I could just simplify it even, it would save us a ton of money just from a compliance level.

Mr. AKIN. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Mr. Chabot, do you have any questions.

Mr. CHABOT. No. Thank you.

Chairwoman VELÁZQUEZ. I have two questions. Dr. Johnson, one of the concerns related to a potential qualification of physical presences, that it would lead to tax avoidance or tax sheltering by corporations. For instance, a business located in one state could diversify its operation and have entities operating in another state, thus creating a tax shelter.

Would enactment of a physical presence standard or any other standard lead to another round of tax planning and tax avoidance, causing states' revenue streams to erode further?

Mr. JOHNSON. I don't believe so, no. In fact, on the contrary, I believe that, as one of my colleagues to my right has said, a clear physical presence de minimis standard clarifies, establishes a bright line relationship.

So that not only would tax avoidance be minimized, but all of the business activity by small businesses that is currently not occurring could now be adequately planned for and budgeted.

So there is no question in my mind whatsoever that a clear boundary is to everyone's benefit, including, obviously, the states, who would then be able to tax properly the resulting revenue from increased activity by small businesses.

Chairwoman VELÁZQUEZ. Mr. Davis?

Mr. DAVIS. No questions.

Chairwoman VELÁZQUEZ. No questions? Okay.

Yes. I would like to ask this question. Anyone in the panel could answer. We have always talked about having a fair and balanced tax system. In terms of progressivity and regressivity, on a scale of one to ten, with one being very regressive and ten being progressive, where would business activity taxes fall on that scale? Dr. Johnson?

Mr. JOHNSON. Madam Chairman, which end is which?

[Laughter.]

Mr. JOHNSON. Which was the progressive number? Which was the regressive number?

Chairwoman VELÁZQUEZ. One regressive.

Mr. JOHNSON. One regressive?

Chairwoman VELÁZQUEZ. Yes.

Mr. JOHNSON. I would say probably a three or a four.

Chairwoman VELÁZQUEZ. Three or four?

Mr. JOHNSON. In terms of business activity tax—

Chairwoman VELÁZQUEZ. Yes.

Mr. JOHNSON. —in terms of total regressivity?

Chairwoman VELÁZQUEZ. Yes.

Mr. JOHNSON. I would say about a three.

Chairwoman VELÁZQUEZ. Any other person? Yes, Mr. Petricone?

Mr. PETRICONE. Well, it's not outright confiscation. So I guess I can't give it a one. I guess I will go with two or three. Again, you know, as you are so aware, small businesses operate so close to the margin. And what they need is a fair tax environment and also some elements of predictability. And this is unfair, and it's entirely random. So it's very troublesome.

Chairwoman VELÁZQUEZ. Mr. Davis, do you have any?

Mr. DAVIS. Thank you, Madam Chairman.

Mr. Rolston, I understand you do business in more than one state. Can you tell me what effect this has on your business?

Mr. ROLSTON. Well, we do business in almost every state. And at this point, I would say this is more of an annoyance than it is a hindrance. We have not stopped business in any state because of this. We have not minimized business in any state. But we have had to increase our effort to deal with these issues in the four states that we currently are addressing these issues with. So if it continues to grow, it will become a larger burden.

We will deal with it. We are a reasonably large company. There are many companies in the North American Association of Food Equipment Manufacturers that are very small and will have to either use outside counsel at a very high price or hire people to deal with it. You know, adding three people to my payroll is not going to put me out of business, but a company that has ten people, adding three is a much more significant burden.

Mr. DAVIS. So when you say increased efforts to deal with it, it actually is more people?

Mr. ROLSTON. Oh, yes, without a doubt, because we have to deal with paying local taxes in all of these different states. So we need people just to administer that.

Mr. DAVIS. And what effect does that have on your business, actually the business that you're really in? Would it be better to go out and hire three more people to sell more product or make more product?

Mr. ROLSTON. Oh, absolutely. I would much rather hire three more salesmen than three more accountants.

Mr. DAVIS. Thank you.

Chairwoman VELÁZQUEZ. Mr. Petricone, you would like to comment?

Mr. PETRICONE. If I could just add? I guess the one thing that I would like to notice, this isn't a static issue. You know, right now we're dealing with a dozen states.

But, you know, every state understandably has every incentive to export its tax burden. So if we end up in a situation we're talking about 20, 30, 50 states and thousands of local jurisdiction, you know, the current situation could get exponentially worse.

Mr. JOHNSON. And, Madam Chair, if I could emphasize, again, from an economic modeling point of view, it may be true that on a case-by-case basis, no particular company will say, "Oh, I'm not going to operate in state X because of the business activity tax."

What will happen, however, is that the intermediaries that make interactive direct marketing possible will have their costs grow imperceptively but enough across the entire economy as a result of these taxes such that businesses who at the margin might have used them will not.

And that is in a sense the dog that doesn't bark, the old Sherlock Holmes principle. What should have happened? The dog should have barked. In this case, there should have been business activity.

Why does it not happen? Because intermediaries are being inappropriately taxed, both in terms of the compliance costs and the direct burden. Costs go up. Businesses choose not to sue them to get to out-of-state markets.

Chairwoman VELÁZQUEZ. Sure.

Mr. DAVIS. As those costs go up, they're doing business in more and more states. I've never really known a business that has control of paying the taxes. That is usually passed on to a consumer. And what effect does it have on the consumer in the economy as we go into this economic down turn that we're looking at right now?

Mr. JOHNSON. Well, again, if I may be the first to speak to that, you know, that $8.9 billion that I mentioned before, that is $8.9 billion of incremental spending, spending that would not otherwise have existed, whether it is spent by the end customer as a consumer or end customer as a small business, it ultimately really does not matter.

And you're right. At the DMA, we just did our quarterly survey of our members' projected economic performance. And, you know, essentially the number of firms in our association who are concerned about recession has essentially doubled just in the last quarter.

I think $8.9 billion in these circumstances in additional sales and the 44,000 jobs, which would be necessary to support that additional demand, is something everybody should be taking very, very seriously in this period.

Mr. DAVIS. Anyone else want to speak to that?

Mr. JOOST. In our business, in each city, we have seven pricing tiers. For example, in Orlando, which is more expensive to do business, say, than Jacksonville or some of our other cities because of economic factors and one of them is local taxation, the people in Orlando pay a dollar more for the same product than they do in Jacksonville because the cost of business is higher. Any time you make the cost of business higher, at some point you've got to pass it on to the consumer.

So to break it down in my world, I can see directly because of all of the different pricing tiers we have to have, where it costs more to do business, people pay more.

Mr. DAVIS. Anyone else? Mr. Godwin?

Mr. GODWIN. I would like to say that right now the boating industry in America is down. It is already soft. So we can't really pass along additional costs to our dealership network because boats are a luxury, a pleasure item. And so, you know, we can't pass that cost. The boating industry is down.

In looking forward, you know, we want to keep people having the ability to come in and buy these boats. And if we continue to shift the cost down to them, they're not going to be able to get into boating.

So thank you.

Mr. DAVIS. Just to follow up on that, then, on the other side, if you can't increase the cost to the consumer, you're probably going to have to put it on your employees. And you potentially have a loss of jobs. Is that—

Mr. GODWIN. That is very true, very true.

Mr. JOOST. Or stop paying their health care.

Mr. ROLSTON. Yes. We are in the same situation. We have a nationwide pricing. So we can't pass it on to the consumer in a particular market because that market is more expensive for us. So

any abnormalities we have to eat. And then that affects our profitability and essentially our employment.

Mr. DAVIS. Well, my time is up. I would just say I have always believed that you can't tax and regulate yourself into prosperity. And I think that is what I hear you saying.

I yield back. Thank you.

Chairwoman VELÁZQUEZ. Thank you.

I want to thank all of the witnesses. Clearly this is a complex and important issue for small businesses when it comes to interstate commerce and BAT. What I intend to do is to send a letter to the Judiciary Committee commenting on this issue so that they could keep the small business perspective of this issue when they consider the legislation that has been introduced.

I ask unanimous consent that members will have five days to submit a statement and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 12:50 p.m., the foregoing matter was concluded.]

NYDIA M. VELAZQUEZ, New York

STEVE CHABOT, Ohio

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
Of the Honorable Nydia M. Velazquez, Chairwoman
United States House of Representatives, Committee on Small Business
Full Committee Hearing: "The Business Activities Taxes and its Impact on Small Businesses."
Thursday, February 14, 2008, 11:30 a.m.

In recent years, the American economy has changed dramatically; shifting away from the manufacture of goods to the delivery of services and intangibles. As a result, many states have sought to strengthen their eroding tax base by levying taxes on businesses that are not located within their jurisdiction.

Today's hearing will focus on the potential problems many small businesses face when engaging in interstate commerce and the impact Business Activity Taxes have on their firms.

As the name implies, Business Activity Taxes, are just that -- taxes imposed by a state for merely conducting business – rather than being physically located within a state's borders. While there are clearly circumstances when this is reasonable, the question becomes whether states are going too far.

This is not the first time this issue has come before Congress. In 1959, Congress enacted the Federal Interstate Income Tax Law to address the matter of a state's ability to affect interstate commerce through taxation. Still in effect today, this law prohibits states from taxing the income of businesses whose only activities are the solicitation of orders for the sale of tangible personal property within that state.

There is concern that this law needs to be clarified to prevent small firms from being unfairly burdened.

Typically, Business Activity Taxes are levied on corporate income generated within the taxing jurisdiction. However, some states have imposed a business and occupation tax based on gross sales, and others have imposed taxes in the form of 'fees' or 'licenses' for products sold within their borders.

This means that a small business software developer may be subject to licensing and use fees in states just for making sales via mail order. If each state charged a $400 licensing fee to that small business owner, it is not hard to imagine the chilling affect this would have on a small company. Having to pay unpredictable taxes inhibits the growth potential for small businesses and our economy at large.

Congress is currently considering whether to provide clarity in this area by setting standards about when a state may invoke its taxing power. And for many small businesses, tax certainty is a primary concern.

Today's hearing will help provide perspective on the scope of the problem. The issue of the BAT is something that has gone under the radar, but has an enormous effect on our economy. The hearing will also provide insight on how any changes to federal law would affect states' ability to tax legitimate economic activity. Limiting the ability of states is something that must be considered carefully. Many of these revenues are used to provide vital services, such as police, fire, and education to their citizens.

The witnesses here today will discuss how the BAT affects their industries. As with most taxes, it impacts small and mid-sized companies to a greater extent than larger entities. Many small firms are completely unaware that they are even subject to these taxes until they receive a bill from a state taxing authority.

Smaller businesses also often lack the resources or capability to comply with the multitude of state and local tax laws that are triggered by Business Activity Taxes. Further, the prospect of challenging an incorrect assessment is costly and time consuming. The issue becomes: how do we ensure clarity for these businesses, while also ensuring that states are not going too far?

While the issue is a complex one, it is important for thousands of businesses across this country. I look forward to today's discussion and appreciate the witnesses coming here to discuss this important matter.

Opening Statement	
Hearing Name	Business Activity Taxes and their Impact on Small Businesses
Committee	Full Committee
Date	2/14/2008

Opening Statement of Ranking Member Chabot

Good morning. Madam Chairwoman, thank you for holding this hearing examining one of the many tax burdens faced by small businesses. I am looking forward to hearing from our distinguished panel of witnesses.

There is no doubt that technological advancements have fundamentally changed the landscape for America's small businesses. No longer are small businesses confined to a regional customer base or disadvantaged by their inability to compete with larger companies because they lack the technological sophistication. In fact, advancements in technology have allowed small businesses to thrive in a global economy now largely dependent on electronic communications, just-in-time deliveries, and streamlined operations – all of which enable companies to decrease costs, increase capital investments, and provide new job opportunities.

Despite these efficiencies, technology has also brought uncertainty – particularly as it relates to the excessive tax burdens faced by our nation's small businesses. Benjamin Franklin once said that nothing in this world is certain but death and taxes. Well, as usual – Ben's right…and in this case, state revenue collectors are taxing America's small businesses to death through the business activity tax.

In 1959, Congress passed, and President Eisenhower signed into law, the *Interstate Income Tax Act*, which remains in effect today. This legislation prohibits states from imposing a tax on businesses whose only contact with a state involves solicitation of orders for tangible goods. Yet, nearly fifty years later, e-commerce and the Internet have greatly expanded the breadth of goods and services available to increasingly sophisticated consumers. Unfortunately, these new avenues of commerce have also become favorite targets of overly-eager tax assessors, who from state-to-state spin a tangled web of rules, regulations, and guidelines – guaranteeing countless headaches for American small business owners.

For example, some states believe that trucks merely passing through the state only a couple times a year – without picking up or delivering goods – have sufficient connections with the state to justify imposing business activity taxes. Horror stories have surfaced describing state tax collectors actually impounding trucks at weigh stations and demanding that companies pay unwarranted business activity taxes on the spot – simply for passing through the state. While they're at it, perhaps the state tax collectors' offices should tax themselves for wasting taxpayers' money. It makes just about as much sense.

These accounts demonstrate the need for legislation that will lower the tax burden and provide greater clarity to small businesses trying to compete in an increasingly global marketplace. Last week, Congressman Boucher and Congressman Goodlatte introduced H.R. 5267, the Business Activity Tax Simplification Act of 2008. This legislation will go a

long way toward accomplishing these objectives by establishing a physical presence nexus standard. It would eliminate the guesswork for small businesses in determining their tax liabilities by setting specific guidelines for states as they seek to tax businesses that actually conduct business within the state.

My home state of Ohio has the regrettable honor of being consistently ranked as one of the worst climates for small business in the entire country. This climate is largely determined by the state's propensity to tax -- individual income taxes, sales taxes, unemployment insurance taxes, and property taxes. Ohio has even begun to impose a gross receipts tax on businesses. These excessive taxes are not the answer to turning the economy around.

Instead, we should be supporting legislation like the Business Activity Tax Simplification Act, which tells entrepreneurs and small business owners that it's okay to invest in our state.

I thank Mr. Boucher and Mr. Goodlatte for introducing this important legislation, and Madam Chairwoman, I commend you for holding this hearing today. I look forward to hearing from our witnesses today.

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Statement of Rep. Jason Altmire
Committee on Small Business Hearing
"Hearing on Business Activity Taxes and
Their Impact on Small Businesses"
February 14, 2008

Thank you, Madam Chairwoman, for holding today's hearing on business activity taxes and the impact they have on small businesses. Many states have begun to levy business activity taxes on small firms that do business in their state, but are based in others. Allowing businesses to do so helps our economy, however, with the growing burden of business activity taxes, many small firms are being forced to reconsider how they do business.

In addition to the burden business activity taxes impose upon a small business, entrepreneurs are often times unaware about the taxes they owe until they receive a bill from a state. The added challenge of disputing an assessment can cost time and money that small business owners just do not have to spare.

As the committee continues to examine this issue, it is my hope that we ensure small business owners are not being unfairly burdened or harmed by these taxes, and that it is not curtailing their economic productivity. I look forward to the testimony we will hear today and I thank the witnesses for lending their time to this important discussion.

Madam Chair, thank you again for holding this important hearing today. I yield back the balance of my time.

# # #

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NAFEM®
North American Association of Food Equipment Manufacturers

Statement of David Rolston, President and CEO of Hatco Corporation, on behalf of the North American Association of Food Manufacturers, at a hearing of the House Committee on Small Business, U.S. House of Representatives, February 14, 2008

The Business Activities Tax and its Impact on Small Businesses

Madam Chairman, committee members, I am David Rolston, President and CEO of Hatco Corporation., a manufacturer of commercial food warming equipment, toasters, and water heaters headquartered in Milwaukee, WI. We have 375 employees, and the company is 100 percent employee-owned.

I also am chair of the Government Relations Committee of the North American Association of Food Equipment Manufacturers, for which I speak today. NAFEM represents more than 600 US companies that manufacture commercial food preparation, cooking, storage and table service equipment and supplies used in restaurants, cafeterias, institutional kitchens, and other commercial food service establishments. Typical products are freezers, refrigerators, stoves, ovens and broilers, food warmers, display tables, serving trays, cutlery, and virtually everything you would see in a commercial restaurant kitchen or food service area.

This is a surprisingly large industry. Total domestic sales are over $8 billion -- and it is an industry composed predominantly of small businesses. Sixty-six percent of the members have sales less than $10 million a year with fewer than 100 employees. We have members from 46 states of the union. Most, like Hatco, are single-state companies, with no physical presence outside their home states.

Efficiency and predictability are essential to a small business. The growing practice of states to assess "business activity" taxes on firms that have no physical presence in the taxing jurisdiction has come as an unpleasant and shocking surprise. If left unchecked, these taxes will become a nightmare for small businesses, increasing our administrative costs, adding an unnecessary layer of inefficiency, and limiting our ability to grow.

Let me give you our example. Hatco, like most NAFEM members, sells through independent manufacturers' representatives who represent 10-15 companies. Hatco also uses independent service agents to complete warranty repairs on our equipment. Again, these independent companies service the equipment of many different manufacturers. Neither of these types of independent companies cause Hatco to have a physical presence outside of Wisconsin. Nonetheless, we are now being forced to pay business activity taxes in four states where we have customers but no physical presence. Justification given by the states for these taxes is the existence of the representatives or service agents.

Of course, our manufacturers' representatives and service agents in these states do pay income taxes on their own business profits. That is as it should be. We should be paying taxes in states where we have presence and receive government services. For us, that is Wisconsin. We should not be paying business activity taxes – which are a form of income tax – where we have no physical presence.

161 North Clark Street • Suite 2020 • Chicago, Illinois 60601-3344 USA
phone +1.312.821.0201 • fax +1.312.821.0202
info@nafem.org • www.nafem.org

We don't know what other states will come at us next. These tax bills catch us by surprise. When states first contact us, they sometimes come on hard. One state originally demanded that we pay eight years of back taxes. This would have been significant. Others have threatened penalties. Litigation, of course, is impractical for a small firm. We try to negotiate, and then we pay up. We can't pass the costs on, so both the tax payments and, even worse, the administrative costs, are off our bottom line.

What are the consequences? Think about where this is going. Facing business activity taxes assessed by four states where we have no presence is bad enough, but 20 states? 30 states? We would have to add staff just to attempt to keep track of these unforeseeable obligations, file the returns, and try to stay clear of penalties and demands for back taxes. These would, of course, be unproductive employees – a hit to our efficiency. And bear in mind that we are a 100 percent employee-owned company. Any added costs hurt every employee.

And what about the overall impact on the economy? The taxes we pay to states where we have no physical presence come off our net profits. So do the administrative costs. As our net income after expenses is reduced, the taxes we owe to Wisconsin and to the federal government also are reduced. After you factor in both the added taxes and the added administrative costs, both to us and to the states, I doubt that anyone is coming out ahead on what the economists would call a macroeconomic level.

Certainly if other states jump on this bandwagon, we will just be spreading the taxes around, with little, if any, net benefit to anyone.

As a small manufacturer in the US, we face many threats from competitors outside our borders. We continue to be successful by staying lean and smart. Adding unnecessary headcount to administer programs like activity taxes makes us less competitive with overseas companies.

For many years, it has been the presumption that businesses pay taxes only in states where they have physical presence and receive government services. We believe the Congress should act to preserve this standard.

Thank you.

Testimony of Barry Godwin

Before the United States House of Representatives
Committee on Small Business

February 14, 2008

I. Introduction

Ms. Chairman and Members of the Committee, thank you for inviting me to express my views concerning "The Business Activities Tax: The Tax Burdens Felt by Small Businesses Engaged in Interstate Commerce" and the issues it addresses.

I am the Controller at Stingray Boat Company. Like most small business managers, I have multiple responsibilities and perform various tasks. Stingray Boat Company was founded by Al Fink in 1979, where Al remains the President of the company. Al Fink remains keenly involved in the company, from its roots to the top. Stingray Boats is located in Hartsville, South Carolina, employing 240 individuals full time. We are, by all standards, the epitome of the American Dream, and a small business proudly dedicated to our employees and their families. Stingray builds fiberglass boats from 18 to 25 feet in length. We ship to almost every state within the United States, Canada, Europe and Australia.

In my testimony, I will relate three differing experiences that I have had with three different states. I am seeking clarification of P.L. 82-272, as each state is interpreting how tax nexus has occurred between us and them. The burden placed upon Stingray is to incur legal fees, accounting fees and time to address each state as they seek to attach an economic nexus to Stingray business activities. This is another tax in addition to the sales tax incurred by the independent dealer in the jurisdiction of that state.

Until three years ago, we were unaware of nexus implications as it relates to taxes. In 2005, we began to hear more about nexus. We became aware of a situation in which the State of New Jersey had stopped another boat manufacturer's boat load due to nexus issues. We researched what nexus meant to us. Our activities within all states are the same. We operate according to P.L. 82-272. Our boats are sold to independent dealers. All orders are taken within the State of South Carolina via the telephone or internet. Boats are paid for before delivery is taken by the dealer. Sales representatives from Stingray may travel to see a dealer from time to time but do not operate a "Stingray office" within that state. Dealers visit Stingray each year to review new products and test drive the boats. The boats

may be delivered to the dealer on our trucks or by a contract carrier. We reimburse the dealer for warranty work performed by them on our boats. We believe we are operating within the law.

II. The State of Maine vs. Stingray

In 2006, a revenue agent from the State of Maine sent a letter to us regarding our actions within that state. I responded to Mr. Flynn (representing the State of Maine), that we believed that we were operating within the confines of the law. After I had completed a nexus questionnaire, Mr. Flynn told us that we had created nexus by paying the independent dealer for warranty work performed on one of our boats. I assume that the dealer paid tax to Maine on the amounts received from us as payment for the work done in Maine. Stingray did not perform the work, but because we had paid the dealer, Maine claimed that our action created nexus. I objected to the revenue agent, but we decided it would be less costly to pay the retroactive taxes and fines than to pursue the matter in the courts. The State of Maine agreed to require us to file tax returns and payments covering the years 2003 through 2005 and to abate any penalties during this period.

III. Washington State vs. Stingray

In mid 2006, we received notification from Washington State that we had created nexus with that state as well. In this case, revenue agent DeLay cited that we had significant activities within the state of Washington which created tax nexus. Mr. DeLay told me that because we were a member of the Northwest Marine Trade Association (NMTA) it demonstrated that maintaining a market in Washington State was crucial to Stingray, thereby creating "significant activity" and nexus. We maintained a membership in the NMTA to receive a manufacturers discount on floor space at the boat show for the dealers in the state and hold our spot for floor space in the future. Because of Washington State's allegations, we have cancelled our membership in the NMTA.

Mr. Delay cited the fact that our sales representative travels to Washington State as another reason Stingray created nexus. Our sales representative, who lives in Nevada, travels to visit the Washington dealer approximately three times per year. Sales calls to the independent dealers are to discuss improvements to the boats and other business issues. This Washington dealer had approached

us to sell Stingrays. The dealer had flown to South Carolina to meet with our vice-president of sales and company president. The dealer tested our product while here and we mutually agreed we would be good for each other. Since being approved, all orders have been taken via the telephone or the internet. I have appealed to the Washington State Department of Revenue the tax ruling by the tax agent and I am awaiting a resolution.

IV. The State of New Jersey vs. Stingray

On July 23rd, 2007 I received a call transferred over from our truck fleet dispatcher at 10:15 am. The person on the other end was Ms. Kostak, a revenue agent for the State of New Jersey. I was immediately told that our truck had been pulled over at the weigh station on the interstate highway and could not move until we paid New Jersey for jeopardy assessment taxes. I asked Ms. Kostak why they were doing this. I was told that we had a dealer in the state of New Jersey. This incident was becoming unbelievable, so I asked her to fax me proof that she was who she said she was. I asked what I could do to let the driver go and I was told to pay the New Jersey Division of Revenue money. I asked how much and I was told it

depended upon our sales into New Jersey. I looked up the sales for the past seven years as requested and Ms. Kostak quoted me a price of $46,200 to release the truck. I then told her I would need to discuss the issue with our company president. Ms. Kostak told me I had until 1pm that day to get them the money or the truck would be impounded and we would need to make arrangements to retrieve the driver. I asked her, "Can I not send you a check or work something out to let the truck pass through New Jersey?" and I was told to wire them the money.

I first talked to our truck driver and asked him what had happened. Our driver was passing through the State of New Jersey carrying a load of boats for delivery into Massachusetts. Our driver told me that the agent pulled his rig over at the weigh station and asked him if we had a boat dealer in New Jersey. The driver had never delivered into New Jersey and told the agent, Ms. Kostak, that he did not know. (Our driver told me that there were ten other trucks stopped at the weigh station for the same interrogation.) Because he did not know whether we have a New Jersey dealer, he gave Ms. Kostak our home office number and the dispatcher's name. Ms. Kostak called our dispatcher and found out that we have a dealer in

New Jersey, asked more probing questions and then was passed over to me.

After talking to Ms. Kostak, I discussed the situation with our company president. We decided to call another boat manufacturer who also had been stopped by a New Jersey revenue agent while transporting boats through New Jersey. Their company president of told us that his boat company had spent over $140,000 in legal fees and the issue was not yet resolved after two years. We were also given contact information for the company's attorney. I contacted the attorney to find out our options. The attorney was not encouraging and did not feel we could win against the State of New Jersey. The attorney told me that it was very likely that unless we paid the amount requested, our trucks would be stopped each time thereafter in New Jersey. The attorney suggested that we pay the amount demanded and then appeal in the tax courts of New Jersey. After consultation with our company's president, we decided to pay what Ms. Kostak demanded so that we could free our load of boats to be delivered and let our driver go.

I called Ms. Kostak again, by now it was close to 12:30 in the afternoon. I told Ms. Kostak that I was appalled by how the State of

New Jersey was operating. I asked her how we had created nexus with New Jersey. I told Ms. Kostak that we believed we were operating within the law. Ms. Kostak told me that because our trucks had delivered our boats into the State of New Jersey that this action created nexus. Ms. Kostak reminded me of the deadline to pay them the money or our boats would be impounded. I knew we had boats to deliver into another state and my only choice was to wire the money, which I did. Ms. Kostak had to certify that the funds were in the bank before releasing our property. Finally, at 1:30pm our truck and driver were on the road again.

When our truck crossed the New Jersey state line, Stingray did not have an outstanding issue, warrant or any other legal matter or business activity with New Jersey. If fact, the State of New Jersey did not know we had an independent dealer in the state. Ms. Kostak gathered "evidence" along the way to invoke a jeopardy assessment against Stingray. The manner in which the State of New Jersey acted is commonly defined as extortion. Fortunately, I have never been the victim of a crime in my life. But, that day in July, I believe I was strong-armed by a state of the United States of America. Under the theory that nexus existed, I and my company were treated like

someone on the run from the law. This entire episode was an unbelievable manner in which to conduct business. Since that day, we have paid New Jersey almost double the original amount that Stingray "owed" in interest and taxes. Lawyers tell me that because of federal law (P.L. 86-272), New Jersey's tax imposition is likely unconstitutional.

V. Conclusion

I thank the Chairwoman and Members of the Committee for inviting me to testify and submit this written statement. I believe that the small businesses of America are well served by the Committee's attention to these issues so important to our survival and future business in America.

I am sure each state within the United States has reason for "interpreting" P.L. 86-272. Unfortunately for small business, the end result is confusion, unexpected costs, another "hat" for small business owners to wear and as testified above a restriction to interstate commerce. I urgently ask that Congress enact the Business Activity Tax Simplification Act recently introduced by Congressmen Boucher, Goodlatte and others to clarify

P.L. 86-272, and thereby ~~to~~ eliminate the unwarranted time and cost burdens placed upon small businesses that participate in interstate commerce.

Testimony of Mr. Stephen Joost, Firehouse Restaurant Group, Jacksonville, Florida

Members of Congress, Ladies and Gentlemen

Thank you for allowing me to testify before your committee today. My name is Stephen Joost. I am the Chief Financial Officer and Principle in Firehouse Restaurant Group, Inc. otherwise known as Firehouse Subs. Firehouse Subs is an emerging national chain of sandwich shops. Currently we have 312 restaurants operating from Las Vegas Nevada to Washington D.C. We started in Jacksonville Florida 13 years ago. Through our franchising efforts we employee over 5,000 people and have achieved national sales of over $200 million. Firehouse Subs has helped numerous employees, franchisees and area representatives achieve their American Dream and yes, some have become very wealthy. On the national level, franchising has also made a tremendous impact on the economy and the entrepreneurial spirit of Americans. According to a 2008 International Franchise Association Educational Foundation study conducted by PricewaterhouseCoopers, there are 909,000 franchised businesses in the United States, employing 21 million workers (directly and indirectly), responsible for $2.3 trillion in annual economic output.

However, during that time, we have come across some serious impediments and challenges to our growth. There are always the usual impediments to growing a business such as competitors coming out with a better product, access to capital, real estate locations, paying competitive wages…etc. However, there have been several artificial barriers, complexities and tax traps created by Government that have hurt my business over the years that have led to unwarranted expenses and wasted money. I am here today to help explain what myself and my company have been through and to add suggestions as to how you can help.

One of the more perplexing problems facing a growing business is interstate commerce. With our system of federal government and independent states, each state is allowed to create its own laws.

This has led to the implementation of many different laws with many different standards. Examples are differing disclosure requirements in our disclosure documents, differing sales tax methods and rates, and differing income tax laws and application thereof to name just a few. These differing laws and standards upon which they are applied have necessitated my company to hire a plethora of tax accountants and lawyers to help us comply with the regulations, file the various tax returns and documents each state requires, and to help us employ various strategies to limit our liabilities. Sometimes I wonder what business I am in.

One of the more disturbing problems created by state governments is that of state income taxes and franchise taxes. As economic growth has slowed, so has state revenue growth. According to Allison Grinnell of the Rockefeller Institute, state tax revenue totaled $147 billion in the third quarter of 2007 — a 4.4 percent increase over the 3rd quarter of 2006. However, when adjusted for legislated tax changes and inflation, total state tax revenue declined by 0.6 percent. Therefore, many states are looking for money. One of the ways they do this is through state income taxes and by taxing corporations who are not located in their state through a mechanism called nexus.

In its simplest form, Nexus means a connection. Certain activities, as insignificant as they may seem, may establish nexus (a connection with a state that subjects you to its tax laws). A company may have unknowingly had nexus with a state for many years. It might even be responsible for back sales tax, franchise tax and/or income taxes, penalty and interest for past years. Examples of creating nexus, that an ordinary person would not think of are having a sales representative solicit business in a state, traveling for a meeting with franchisees in a state, traveling to inspect a store, even the mere solicitation of business in a state without having ever entered the state can trigger nexus rules.

Worse yet, the nexus standards between states vary widely, and wildly. Furthermore, the nexus standards within a state can also vary depending on what tax is being imposed. For example the nexus standards for franchise taxes can be much broader than they are for income taxes. This means that companies that could be exempt from paying income taxes in a certain state may have a franchise tax liability if they do business in that state depending on how that state defines nexus.
Furthermore, since each state has its own departments of revenue, interpretations on how the laws are applied can change.

Once a nexus is established, states also get into the game of apportionment. Apportionment is a formula to figure out how much income is attributable to a specific state's income tax. These apportionment rules are often changed by the individual states to help them garner an advantage over other states.

Currently, my view on the subject matter is the way states are imposing burdensome rules, and changing them every year is, first it is an unfair tax on intellectual property and secondly it has created a subsidy for lawyers and accountants. The fact that the whole Firehouse Subs concept was created in Jacksonville Florida and the fact that franchisees pay us a royalty for the use of our name, our products, our training and methods of operation should not involve other states. All the intellectual property, trademarks, and business practices were created in Jacksonville. When people pay us for the use of this property, that is the essence of franchising. I have not heard of other states taxing the real physical property of other states and yet while intellectual property can not necessarily be consumed or touched, it is none the less of the same and sometimes more value than real physical property.

I believe these rules more specifically have created an unintended attack on the franchise business. While I know I am not, nor my company is opposed to paying taxes, we are opposed to having to

spend hundreds of thousands of dollars to figure out how to do it because we have to hire an army of accountants and lawyers to do it. What is needed, and what I would recommend is a single set of rules defining what constitutes nexus and how it will be applied in the 50 states. More importantly, nexus should be defined in a more conservative and common sense way than is being commonly applied today. The fact that if I merely step foot in a state creates a taxing event is incredulous. Even at the end of the day, if I did not agree with your definition of nexus, that fact that there was one standard applied across the country would be a great relief to myself, my company and to the franchise world.

Thank you for hearing me out today. I hope my testimony has helped shed some light on this very important topic. If you have any questions I will be happy to answer them.

Before the
House Committee on Small Business

Business Activity Tax
and Its Impact on Small Businesses

February 14, 2008

Written Statement of Michael Petricone
Senior Vice President, Government Affairs
Consumer Electronics Association

On behalf of the Consumer Electronics Association (CEA), I appreciate the opportunity to appear before you today to highlight a critical issue impacting American small businesses.

By way of background, CEA is the premiere U.S. trade association that represents the $161 billion consumer electronics industry. We are also the owners and producers of America's largest annual tradeshow, the International CES, held every January in Las Vegas Nevada.

Our more than 2,200 members are involved in the design, development, manufacturing, distribution and integration of audio, video, in-vehicle electronics, wireless and landline communication, information technology, home networking, multimedia and accessory products, as well as related services that are sold through consumer channels. CEA's members include virtually all of America's top technology companies as well as many of the leading retailers.

Approximately eighty percent of our members are small businesses. In fact, our small business members are located in each state represented on this Committee. At the 2008 International CES, almost 1,000 small businesses exhibited; confirming that true American entrepreneurship is alive and well.

Small businesses are the life blood of the United States economy. Given our recent economic uncertainly, it is more important than ever that our legal environment allows small business to thrive. To do so, they need to be subject to consistent regulatory treatment, and fair

and predictable taxation. Unfortunately, our small businesses are now being threatened with onerous and inappropriate taxation by the states. Congress needs to act quickly to stop this alarming trend.

Specifically, an increasing number of states are using "economic nexus" theories to levy income and franchise taxes against out of state companies that have customers but no physical presence in the taxing state. These taxes chill investment and violate the U.S. constitution by unduly burdening the free flow of interstate commerce.

The problem is growing. As of today, a dozen states have developed a statute or regulation that establishes an economic nexus without a physical presence. Several others have made a similar decision at the administrative or judicial levels.

The problems engendered by this growing "crazy quilt" of state levies are obvious. Small businesses are faced with burgeoning compliance costs. They face an unclear business environment with no way of estimating where and when they will be taxed. Business expansion is chilled, especially when it comes to electronic commerce which inherently crosses state borders. And companies face the risk of duplicative taxation, since they also face legitimate taxes from the states in which they are domiciled.

Atlantic Technology, a small business based in Norwood MA, is a typical example. A true model of American ingenuity, Atlantic Technology was founded in 1989 by Peter Tribeman and produces a variety of home entertainment products, including high-performance multi-channel speaker systems and state-of-the-art home theater electronics components. Although the company has no physical presence in the state of Washington, Washington's Department of Revenue has continually taxed Atlantic Technology because of their use of independent sales representatives. While the company contested this assessment, they were faced with additional

tax levies by other states including Pennsylvania and Florida. Fighting this barrage of state taxes will require the use of scarce resources that should be going toward building the business.

Mitek, a family-owned and operated business, which is based in Phoenix, Arizona, is facing a similar fight. Mitek produces well-known mobile audio brands such as MTX Audio and StreetWires. Mitek has been hit with business activity taxes in several states, including California, Washington and Michigan, strictly based on the use of nonexclusive independent representatives.

For Atlantic Technology, Mitek and numerous other companies that are forced to pay taxes in states where their company has no physical presence; these taxes are negatively impacting innovation and the overall economy. The continued growth of the consumer electronics industry is due in part to the success of the Internet, which has created a national market for many small businesses. Unfortunately, the threat of being subject to out-of-state business taxes may lead some companies to cut ties and refuse serve customers.

It is imperative for Congress to step in and assume its constitutional responsibility to ensure that commerce is not harmed by unfair taxation. The Business Activity Tax Simplification Act, H.R. 5627 would provide the much needed relief to small businesses. We applaud the leadership of Representatives Rick Boucher (D-VA) and Bob Goodlatte (R-VA) in introducing this important legislation. H.R. 5627 will provide clarity by providing a bright line definition of physical presence. Most importantly, it provides relief to business by clearly preempting states from taxing corporations with no physical presence.

Let me be clear - our member companies are not asking for relief from legitimate taxation. We are asking to restore a simple principle: a tax should not be imposed by a state unless that state provides benefits or protections to the taxpayer. H.R. 5627 will not result in

reduction in taxes paid by businesses. Rather, the bill provides that only businesses receiving state and local benefits derived from such taxation like education, transportation, fire and police, should be subject to such taxes. Furthermore, the legislation will not impact states' ability to collect income or other legitimate taxes from its residents.

Congress has historically acted to invoke its Commerce Clause authority. For example, Congress enacted the Federal Aviation Act to prohibit states from imposing "flyover taxes," ensuring that aircrafts were only taxed by states where they take off and land. Recently, Congress enacted legislation to prohibit taxing Internet access and prohibit multiple or discriminatory taxes on electronic commerce. We urge Congress to act again to provide relief to small businesses that carry the heaviest burden when subjected to these predatory taxes.

As you know, small companies with fewer than 20 employees already spend significantly more per employee to comply with federal regulations, including tax compliance when compared to larger businesses. With this in mind, we need to protect small business from inappropriate taxation. This legislation will provide relief and greater clarity for small businesses, which are the lifeblood of the U.S. economy. Therefore, I respectfully urge you to say no to taxation without representation and support the Business Activity Tax Simplification Act (BATSA).

ROLLING BACK DISCRIMINATORY BURDENS AGAINST DIRECT-TO-CUSTOMER INTER-STATE COMMERCE:

THE ECONOMIC IMPORTANCE OF A DE MINIMUS PHYSICAL PRESENCE TEST

Peter A. Johnson, Ph.D.
Senior Economist
Vice-President, Research Strategy and Platforms
Direct Marketing Association

Thursday, February 14, 2008

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I INTRODUCTION

Madam Chair, Members of the Committee, I want to thank you for the opportunity to testify on the economic importance of reforming BAT. I am Peter Johnson, Vice President for Research Strategy and Platforms and Senior Economist of the Direct Marketing Association ("DMA"). I am in my seventh year serving the DMA in this capacity, having taught economic policy at Columbia University in New York City full time from 1991 to 2000.[1]

The DMA is the largest trade association for businesses delivering value to customers directly. Founded in 1917, the DMA today has over 4,700 member companies in the United States and 53 foreign countries. The membership of the DMA has had a long-standing interest in helping policy makers understand the legal and tax underpinnings of inter-state commerce. My research on the physical presence test in regard to the amount of uncollected sales or use taxes arising from Quill protections of Internet Commerce has been presented before other committees on several different occasions by my colleagues at the DMA, and cited by others before hearings at the state level in Florida, Illinois, Virginia and California, among others.

I wish to emphasize that I am neither a tax attorney nor a Government Relations professional. In today's testimony I hope to bring an economic perspective to the debate surrounding Business Activity Taxes. I hope these will encourage you to undertake these most needed reforms.

II. ARGUMENT IN BRIEF

Our tax counsel, George Isaacson, has made clear the DMA's position regarding these issues from the perspective of the Constitution and Federalism. Our position has been, and continues to be, that a clear physical presence standard for nexus is appropriate, whether in regard to BAT or transaction taxes. Without such a test, state tax policy risks

[1] I would particularly like to thank my colleagues Mark Micali, George Isaacson, Anne Frankel, Michelle Carrera, and Dr. Yory Wurmser in preparing this testimony.

running afoul of the Interstate Commerce clause, and becoming economically burdensome and discriminatory.

Speaking as the DMA economist, my purpose today is to make clear the economic implications of the physical presence test, and the reduction in discriminatory burdens to which we hope it will lead.

As I review the policy debate concerning BAT reform, I note most of it has focused on the size of tax loss to state treasuries. Opponents of HR 5267 and its predecessors point to the expected loss to state treasuries, and claim that without the right to levy BAT, local commerce will continue to pay tax, while inter-state commerce is asking for special treatment, and seeking to avoid shouldering its fair share of the costs of state services.

Framing the debate in terms of local commerce and inter-state commerce is terribly misleading. What this debate is really about is whether state tax policies should be used to divert interstate commerce through one set of marketing channels as opposed to another. The concern about losses to State revenues is only part of the story. The rest of the story is how Business Activity Taxes by their nature are economically rational for one type of interstate marketing, but represent a discriminatory burden for another.

Thus, in the remarks that follow, I intend to show first what these two types of interstate commerce look like from a marketer's perspective; second, how BAT fits with one but discriminates against the other; and third, the wider economic gains to be had by releasing direct marketing from these discriminatory burdens through a clear physical presence test.

III. TWO FORMS OF INTER-STATE COMMERCE: ORIGINAL MARKETING VS. DESTINATION MARKETING

To defend the claim that BAT is burdensome and discriminatory to direct marketing, one must consider not only the absolute level of taxes posed, but the relative impact on the underlying efficiencies of the business models involved.

From a historical perspective, interstate commerce begins on the demand side, with national manufacturing in the nineteenth century. The development of national transportation networks of canals, railroads, and then interstate highways and air transportation offered increasing returns to scale in the mass manufacture and shipment of physical products. This is, of course, fairly obvious, and not what is at stake in BAT reform.

What is at stake in BAT reform is how these nationally manufactured or distributed products would reach their end customer on the demand side, i.e., the households or small businesses scattered across what would eventually be an entire continent, divided into 50 separate states and thousands of sub-state jurisdictions. To bring their goods to their end

customers across America's vast distance required national manufacturers to develop and use efficient marketing channels.

Let me be clear what I mean by marketing channels. These are the set of planned business activities undertaken to bring potential buyers and sellers into contact with each other, then facilitate transactions among those who wish to do so. In economic language, marketing channels seek to reduce both "search" and "transaction" costs.

Over time, it has become clear that for national manufacturers to reach the full range of their end customers required the development of two distinct types of marketing channels. The first of these, mass marketing, invests in physical infrastructure of retail outlets that capture increasing returns to scale in transportation and communication channels to supply geographically-concentrated markets. The other form, direct marketing, capitalizes on increasing returns to scope in third-party communication and distribution channels to aggregate end-customers across geographically dispersed markets.

In principle the two forms of inter-state marketing complement one another. A fully efficient national economy would combine the two in ways that reflect the efficiencies scale and scope offered by the marketing channels at any given time. However, these marketing channels also represent revenue streams for taxing authorities. Tax policy decisions represent sticky investments by public authorities that tend to divert business activity towards one set of channels and away from another.

This facts concerns both national sellers and end-customers who find it more cost effective to use direct marketing to find each other like needles in the haystack that is the national economy of 250 million consumers and some 3 million or more businesses. And because finding each other requires them to cross so many legal jurisdictions, direct marketing sellers and end customers are uniquely vulnerable to the collective decisions of these thousands of taxing authorities.

Mass Marketing: Geographic Concentration From The Response Monopoly

Mass marketing is essentially a form of indirect marketing, in which the national manufacturer or seller is separated from the end-customer by business intermediaries of wholesalers and above all, geographically concentrated retailers. While this separation of ultimate seller from ultimate buyer is to some degree a natural by product of economies of scale in transportation costs, the extent of this separation is not, nor is the degree of economic concentration in mass retailing this now represents.

The twentieth century's large and increasing returns to scale of geographically concentrated retail channels is largely an artifact of the economics of mass communication media, particularly the domination enjoyed in the twentieth century by mass produced newspapers and electronic broadcast media. During this era, the economics of mass "one to many" communications" made it highly cost-effective for

national manufacturers to generate publicity about the lower cost, reliability and availability of their products by making large purchases of advertising space in urban newspapers, and then large blocks of time on broadcast radio and television networks. Their goal is what marketers now refer to as "brand awareness".

From an economic point of view brand awareness was really only a poor substitute for the thing that mattered: sales to end customers. Because neither newspapers nor electronic broadcast media offered two-way communications in much of the twentieth century, the end-customer's primary (usually, their only) response channel (ie way of purchasing) was a local retail outlet.

It is their local monopoly as the response channel that ultimately shifted the economic balance of power away from national manufacturers and towards retailers. By making their own media buys, large retailers could advertise the fact they carried – and discounted – nationally manufactured brands. Because they bore the risks associated with unsold goods, and controlled the end pricing, proprietors of retail outlets soon discovered they enjoyed increasing returns to scale of their own, returns to scale that were often superior to those of national manufacturers or distributors.

To the returns to scale offered by their dominance of the response channel, retailers could further reduce transaction costs for their end consumer by locating in population centers with low cost transportation nodes. Together, these increased returns to scale promoted a progressive concentration of retail outlets, forcing local grocery and hardware stores to lose competitiveness to supermarkets and department stores, who in turn consolidated into city-wide retail chains. In turn, these urban supermarkets and department stores became less price competitive than suburban shopping centers, until ultimately, big box retailers emerged as the most price retail channels so far.

Destination-Based Marketing: Direct Marketing

For all the competitive price efficiencies achieved by mass-market retail channels, it is important to recognize there are inefficiencies inherent in geographically concentrated mass market retailing that even now are not fully appreciated.

In particular, demand from individual end-customers who share a specialized need or want must often be sacrificed by geographically concentrated mass marketing's quest for economies of scale in transaction costs. So too must new products, or offerings from new national suppliers that do not fit the cost structures demanded by mass marketers.

Direct marketing's comparative advantage over mass marketing lies in its ability to maintain the direct connection between a national or regional seller and their end customer. Given the superior economies of scale for mass marketing of commodities, however, direct marketers can generally only do so profitably by aggregating demand that is thinly dispersed across a wide number of separate geographic destinations into a pool that is large enough to be served economically.

Allow me to present this business model of serving dispersed end-customer markets in a little detail. To create such "virtual" markets of dispersed end-customers, direct marketing must invest heavily in reducing search-costs both for themselves and end customers, while asking end-customers to bear some of the cost and risk in transacting.

Direct marketers reduce search costs for themselves by first investing in lists of prospects or customers. These individuals will be selected for promotions based on their probable response behavior – i.e. a likelihood of buying a particular type of product or service, often as revealed by having bought a similar type of product in the recent past. Because communicating offers on this individualized basis expensive, direct marketers developed statistical and financial disciplines to reduce expenditure on promotions to potential buyers who are less likely to respond to their product offers, and concentrate only on those that are more likely.

It is the ability to track and predict customer response that is the main driver of efficiency in direct marketing. To take advantage of economies of scope in aggregating end-customers, communications channels need to direct observe response by the end-customer to the offer. To minimize responses diverted to retail channels and minimize lost response arising from unnecessary search costs borne by the end customer, it becomes economically necessary for direct marketer to shoulder their end-customers' search costs as well.

This capacity to track and analyze response is itself determined by the availability of communications channels that allow end customers to respond through channels other than retail middle-men. Unfortunately, for many years, the only nationally efficient network which allowed end customers to respond to them at an affordable price was the national postal network..[2]

The second major way in which direct marketers absorbed search costs was through the use of introductory offers for new customers. Because many buyers are unsure of the value of products offered them at distance from firms with which they were not previously acquainted, there is an implicit new customer 'discount' that had to be over come through special discounts not offered to previous buyers. Such subsidies to new customers were often a necessary loss that would recouped only from a certain fraction of such new customers who convert as repeat customers with a high life-time value (LTV), and for which rigorous financial analysis is required.

It is in how direct marketing addresses transaction costs for end customers, especially in fulfillment, that the virtual marketplace is at a relative disadvantage. Most obviously,

[2] Not until the deregulation of long-distance charges and the development of toll-free dialing (800 numbers) could direct marketers speed response time through electronic communications. This allowed marketers to introduce response-based advertising in print and broadcast, but only on limited basis for space and time that was sold in 'spot' markets. In fact, FCC regulations for many years actually required that such advertising spots only be made available merchants of products that were not available in stores; hence the famous phrase "not available in any store."

national vendors face shipping and handling costs that are on average substantially higher than is the case for mass marketers. To contain total transaction costs the marketer must be able to incur transportation and settlement charges on a variable cost basis. This means they must be able to engage the services of common carriers with increasing returns to scope in their delivery or fulfillment charges on an as-needed basis.

Even so, higher average transaction costs have historically placed strict limitations on the range of product offers which marketers could expect customers to respond to, and have delivered to them on a variable-cost basis. Initially, when the only addressable network was the Post Office, products that could be marketed in this way were often limited to small or content-based products, such as magazines, hobby and craft items, apparel, toys or credit-card offers, etc. that could be sent as printed matter or parcel post. (The exception was when the end-customer was so far distant from retail outlets that the high fulfillment costs represented a small fraction of the final price.)

Even given this limited range of products, the economics of the virtual marketers generally require the end-customer to bear a portion of the distribution and settlement costs and risks. This includes cost of shipment in the event of returns. This is something mass marketers generally do not. Indeed, doing so is often necessary to distinguish serious customers or prospects from those who are merely "window shopping."

Economic Benefits From Direct Marketing.

Most obviously, the first beneficiary of this marketing method are end customers with specialized needs that are not met through mass marketing channels. By investing in lists and predictive analysis to identify prospects most likely to respond to their offers, absorbing their response costs, and by avoiding the overhead costs involved in physical infrastructure, direct marketers discovered they could identify and serve latent demand within widely dispersed markets that could not be efficiently served by traditional marketers' focus on reduced transaction costs to geographically concentrated markets.

The second benefit accrues to small businesses. When fully integrated throughout the organization, direct marketing processes increase the organization's overall efficiency, eliminating waste throughout the organization, leading to highly focused efforts in every area from initial product research and development decisions through final customer sales and service. With initial overhead investment in physical infrastructure minimal, and variable marketing costs, there are relatively low barriers to entry.

Historically, because of the response monopoly enjoyed by local retailers, efficiencies that could be achieved by investing in returns to scale in lower transaction costs greatly outweighed those available to direct marketers. At some point in the growth of direct marketing businesses, therefore, there often would come a point in which the volume of customers so constructed shifts the logic from direct to mass marketing. Many of today's most famous multi–channel retailers (i.e., retailers with both retail stores, Internet websites, and, in some cases, catalog operations) began as pure-play direct marketers but

who, once they achieved a certain sales threshold, found it more efficient to complement their direct sales by opening retail distribution networks.

What has changed over the years is that the relative returns to scope have improved relative to the increasing returns to scale. This is largely thanks to the proliferation of response-based channels, particularly the Internet, and databases that further increase the returns to scope in employing remote response channels.

Indeed, as can be seen from the accompany tables 1 and 2, direct-marketing based non-store retailers represents a small fraction of total retail commerce – roughly 5% of the total number of firms, and slightly larger proportion of total sales in this sector. Yet non-store direct sellers are significantly smaller and more efficient. This trend is increasing, as mass marketers continue to consolidate, and direct marketers continue to embrace new market entrants.

In fact, even before the emergence of Internet commerce, the non-store retail sector the average number of employees was about 10% less than in the traditional retail sector, and for each employee, these small direct marketing businesses achieved about 25% more sales. As the Internet has increased direct marketing's ability to compete nationally, by offering more customer response opportunities, the trend to smaller businesses in non-store retailing has intensified. The average number of employees in mass marketing retail firms can be estimated to be about 14.1 in 2007, a 12% increase in average size.

Today, average return on investment in direct marketing channels is over $11; in mass, it is in the vicinity of $6.

Secondarily, more and more product for sale via interstate commerce is "content"-based that can now be transmitted digitally rather than shipped in bulky analog format. Even in the age of Google, direct marketers are investing heavily in both paid and organic "search" by customers.

For all these reasons, large geographically based mass marketers are increasingly concerned about their long-term competitiveness. And they should be. The number of non-store retailing firms has continued to decline, dropping an estimated 3% in the last decade. While their total sales increased 52% in this period, total sales in the non-store sector increased in the same period, by my calculations, by about 130%.

So while mass marketers are clearly not suffering in terms of absolute growth, they are clearly losing competitiveness in relation to the smaller and more nimble competition fostered by direct marketing. It should nor surprise us, therefore, if many of traditional mass retailers see a potential competitive burden on their smaller direct competitors from state and local tax structures as not a bad thing.

THE PHYSICAL PRESENCE TEST IN INTER-STATE COMMERCE.

As I hope is clear from the broad-brush picture I have just painted, direct marketing is not different because it is interstate – mass marketing retail distribution is also. Nor is direct marketing synonymous with inter-state retail distribution of tangible consumer goods. In fact, thanks to the proliferation of addressable communications and distribution channels, increased efficiencies in data measurement and analysis processes, and the proliferation of content-rich products and services, direct marketing is increasingly utilized at the local and regional level also.

What is crucial is direct marketing's ability to bring end customers and sellers together directly. But because some direct marketing efficiencies can only be realized by aggregating customers from across all 50 states, and 30,000 sub-state jurisdictions, these efficiencies are acutely vulnerable to taxes imposed at the sub-national level. To put the BAT controversy in context, it must be recognized that the physical presence test originated in the arena of transaction taxes as protection against administrative policies tailored with the economic efficiencies of geographically concentrated marketing in mind.

Origin of the Physical Presence Test: Transaction Taxes.

By the twenties, mass marketing advantages enjoyed by broadcast media created a boom in transactions in tangible goods available for sale in supermarkets, department store, franchises, and dealerships. State and local tax authorities found it economically rational to shift more of their total tax revenues to consumers by levying transaction (sales) taxes.

As a matter of law, transaction taxes are levied on the purchaser, and are owed to the jurisdiction where the purchaser resides. However, because of the large number of transactions involved and the accompany regulatory issues between taxable and exempt products, excluded transactions, filing requirements, audit arrangements and appeal procedures, such a pure "destination" basis would have raised transaction costs substantially. Such a policy would have undercut the basic economic logic of the origin-based marketing model.

So, as a matter of tax administration, these transaction taxes were converted to Business to Government ("B-to-G") taxes payable by the retailer, who could use their economies of scale to collect the tax much more efficiently at the point of sale as a "C-to-B" tax. Thus, what in law began (and technically still remains) a 'destination' sourced tax became, from the point of view of administrative convenience, de facto origin-sourced.[3]

Because of the economies of scale involved, this burden on local retailing was far less than if consumers were asked to bear the compliance costs directly. Moreover, the tax was compensated for in other ways. Retailers increasingly came to seek, and states and localities, to grant, substantial tax breaks and incentives such as tax increment financing,

[3] This can be seen in the fact that local retailers are ultimately liable to the state for transaction taxes owed, even if they chose not to collect them from their end-customers.

to encourage them to locate stores within the relevant jurisdiction. In addition, indirect subsidies have increasingly been provided to large chain store retailers by states and localities in the form of municipal bond financing, infrastructure construction, and even the use of eminent domain.[4] All these policies are consistent with traditional retailers' overall competitive strategy of increased sales through lower transaction costs.

Similarly, local retailers also encouraged states to impose this origin-based administrative system on direct marketers by requiring them to collect and remit taxes also. On appeal, the Supreme Court consistently held that such an arrangement was, from the point of view of both due process and the inter-state commerce clauses, both unfair and economically burdensome. Most obviously, out–of–state companies had no way to influence the state and local tax burdens that are imposed on them. Moreover, the compliance burden placed on sellers that was resolved for mass marketers by the administrative convenience of origin-based administration produced the opposite effect when magnified across all 30,000 jurisdictions with the authority to levy transaction based taxes.[5]

Thus was born the physical presence test. In this test, the court originally stipulated that an out of state retailer could not be required to collect and remit transaction taxes unless it had at least one retail outlet within the borders of the taxing jurisdiction. In the realm of transaction taxes, the physical presence test prevents the administrative solution that serves local retail interests in reducing transaction costs from disproportionately burdening its destination-based business model, even to the point of annihilating it.

Evolution of the Physical Presence Test.

The court recognized that interstate commerce continued to grow as a share of state and local economic activity, and that state taxes needed to accommodate this. In subsequent holdings regarding the physical presence test over a number of years the Court did two things which allowed interstate commerce to grow organically, and state transaction revenues to grow with it.

First, the court broadened the physical presence test to incorporate more types of physical presence. What once required retail stores came to include other physical infrastructure as well: warehouses, distribution centers, offices, permanent sales forces, trucking facilities, and so on. All these were consistent with an appropriate state interest in making inter-state commerce pay its fair share of local and state service which it was physically present to enjoy.

Indeed, the perceived "problem" of internet vendors not collecting use tax has proven to be largely self–correcting. As remote sellers grow, most of them

[4] Needless to say, 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.
[5] Currently, more than 7,500 of the 30,000 have chosen to impose transactional taxes, and the number grows every year

embark on a multi–channel sales strategy, which includes not only opening more retail stores, but warehouses, distribution centers, and the like. Thus, numerous direct marketers began to collect state sales/use taxes naturally, as their organic business growth led them to acquire nexus in more and more jurisdictions.[6]

Simultaneously, however, the Court accompanied this widening of the physical presence test by the preservation of a de minimus threshold. The presence had to be physical, not merely transactional or economic; and the presence could not be indirect, such as through the use of communication networks to solicit business, nor the mere use of common carriers to fulfill orders. In this way, the physical presence test standard which allowed state and local authorities to tax the growing amount of interstate commerce, but in ways that were consistent with the two basic marketing relationships involved.

Physical Presence Test and Business Activity Taxes.

Despite this naturally balanced approach struck by the physical presence test doctrine in the realm of use taxes, the application of the physical presence test to other tax streams has been unsettled. States and their constituencies of geographically concentrated mass marketers have grown concerned by the erosion of their base in transaction taxes. As a result, they have sought to expand their revenue streams by imposing so-called business activity taxes.

As with destination-based taxation of transaction, revenue based transactions on direct marketing relationships in themselves are not only procedurally unfair but violate the spirit of federalism. To quote the DMA's tax counsel, George Isaacson, "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."

BATs have two principal features of concern here. In both features, BAT taxes penalize direct marketers for investing in serving geographically dispersed markets.

First, such taxes may involve a state or locality assess "revenue" taxes on the evidence of a mere economic presence, such as promotion marketing activity into a given locality.

Taxes levied on a revenue basis across multiple jurisdictions without a physical presence test risks is an invitation to arbitrary assessments as to what portion of a firms' revenue is actually attributable to a given jurisdiction. Since the marketer will be liable for the full amount of income taxes owed to the jurisdictions it is domiciled or has other physical presence, there is a significant risk of double-taxation. In BATs, there is no inter-state reconciliation process to avoid double taxation, as there is among states and personal income tax.

[6] 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.

This is especially significant, given that for many direct marketers net income cannot be directly inferred from the volume of revenues flowing from current year marketing efforts. As noted earlier, many current-year customers are newly acquired customers that incur loss. For state tax authorities unfamiliar with direct marketing business models, it will simply not be possible to ascertain those which are actual sources of net income simply by noting the volume of responses. Usually, the firm itself can only ascertain this after the elapse of time, and across the full sum of its marketing efforts, using life-time value accounting.

Second, they can involve imposing taxes on common carriers and other parts of the national distribution network that are indispensable if direct marketers are to operate efficiently on a variable costs basis. By imposing out of state revenue taxes on the third-party infrastructure necessary to variable cost pricing of delivery, particularly imposing revenue taxes on common-carriers, revenue taxes raise the average cost of fulfilling orders to end customers, a fact that is particularly damaging to this business model.

To both of the above direct burdens must be added the question of compliance costs.

As we have seen, direct marketing firms are typically smaller, and the number of jurisdictions to which they must market in order to achieve economic efficiency are more numerous. Thus, the number of discrete jurisdictions for which they will have to incur BAT compliance costs for which there are not economies of scale is large. These costs and the associated risks of audits and litigation are proportionately higher. In the remote sales tax area, we have seen these compliance costs are typically four times higher, on average than for mass marketers, representing up 10% of total value owed, in comparison with the large mass retailers, whose costs represent somewhat more than 2%.

What is the likely economic gain from a bright line physical presence test?

The starting point for an economic impact analysis of tax reform legislation is the amount accruing to state budgets. According to assessments of an earlier version of this legislation undertaken by the Congressional Budget Office, the National Governors Association, and Ernst and Young, there could be some $400m to $4bn of revenues in state and local coffers arising from unreformed BAT taxes in the near and short term.

The second step in estimating the gain to the economy is to know what portion of it is derived from the burdened industries. Of this amount, I estimate that an initial $1.25 billion represents the value that would be returned to direct marketing-based interstate commerce thanks to a clear physical presence test.

To arrive at this figure, I relied upon the Ernst and Young study to estimate the discrete impact effects of the bill's principal provisions. However, in determining the amount derived from "remote" sellers, the E and Y study used federal data from 1992 – i.e, a version of the landscape that is now fifteen years out of date. Thus, I adjusted their break down by estimating a more current estimate of the distribution of remote marketing

activity across industry groups. This more current amount still fell within the lower range of estimates for 2005 losses from the three studies.

This figure I adjusted downwards by about one-third, reflecting what I take to be the net effect of modifications recently introduced in HR 5267. To update the original 2005 estimate for the year 2008 I then estimated an overall increase arising from changes in nominal GDP, and a slight trend increase in state and local application of BAT to operations without nexus.

The figure of $1.25 billion represents only the initial tax relief. To calculate total relief, I next estimated the value of compliance costs that would not be incurred. These I assumed to be 7.6% of total taxes paid, which adds a further $95m in relief, bringing the immediate relief to $1.345bn.

The next step is determine what effect the transfer of this sum money from the state sector to the direct marketing sector would have. Within the context of the economic analysis I have outlined above, this total tax relief represents a net cost reduction for direct marketing channels, making them more attractive at the margin relative to mass marketing.

Taking into account current price elasticities of demand by national marketers between mass and direct-marketing, a net reduction in state-imposed costs to direct marketing will mean that $755 million dollars in expenditure that is currently uneconomic thanks to BAT will be spent. As is summarized in the accompanying table 3, because of direct marketing's overall more efficient return on investment in the sectors concerned, this would result in at least $8.9 bn in additional revenue to US firms in 2008, and $11.5 bn in 2012. This additional economic activity would involve an incremental employment gain throughout the economy for one year of 44,000 jobs, which would increase to 49,000 jobs within 5 years.

Conclusion

Although preliminary estimates that cannot take into account the provisions of the final legislation, these numbers suggest that a clear physical presence test, along the lines envisioned by HR 5267, represents an opportunity to help small business, strengthen America's immediate economic output, and secure its long-term economic growth rate. Direct Marketing will bring wider economic benefits to US economic output, growth, employment, and the small business sector.

In fact, for any given level of taxes accruing to treasuries from BAT, a disproportionate level of burden is placed on direct marketers than if theoretical and empirical economic reasons to believe the cumulative impact is more discriminatory to direct marketers than to mass marketers. In turn, because direct marketing is now economically more efficient than mass marketing, these discriminatory taxes placed on direct marketing are more

burdensome to the economy than if an equivalent level of taxation had been imposed on other forms of marketing.

As the provisions of this bill are debated and amended, the specific economic impact will likely change. This makes future cost-benefit analyses attached to any particular bill dependent on the framework of the debate itself. As a nation, we are now a decade into a national conversation about how best to tailor the economics of tax regimes to capture the economic virtues of the virtual marketplace.

As we have seen, the physical presence test cuts across BAT reform and other policy domains. Because the economic theory of this virtual marketplace has been too little understood, we have had a debate that has focused too much on symptoms, such as lost to specific state revenue streams, rather than overall state tax revenues; and debated the issues indirectly, such as by focusing on legal precedents, rather than directly, by attempting to understand what works for the overall competitiveness of the economy.

A clear understanding of the comparative economic advantages of these two types of inter-state commerce, one virtual, one physical, help place the importance of the physical presence test in its proper context. A clear bright-line *de minimus* physical presence test is appropriate across a range of policy domains. In the case of BAT, it will lead to reforms which can be expected to liberate a more efficient way of doing business from backward-facing tax policies. Their ultimate result, unintentionally or not, is a short-sighted effort to restore the competitiveness of brick and mortar interstate commerce, not by making it more efficient, but by making direct marketing less so.

In liberating the virtual economy from tax structures designed for the physical era of interstate commerce does not privilege any particular industry or segment of the population. It will allow direct marketing to help a wider range of small businesses and customers find each other at a time when mass marketing increasingly stands in their way.

Table 1: Traditional Retail Economic Performance

Traditional Retail (Excluding Non-Store)	1997	2002	2007 (Est'd)	97- 07 % Chg
Number of Firms	1,073,965	1,056,062	1,038,159	-3.3%
Sales ($1,000)	$2,347,765,853	$2,880,817,657	$3,574,176,765	52.2%
Average Revenue ($1,000)	$2,186	$2,728	$3,269.7	49.6%
Total Employees	13,485,110	14,051,790	14,618,470	8.4%
Average Employees	12.6	13.3	14.1	12.1%
Efficiency ($1000 Sales/Employee)	$174.1	$205.0	$244.5	40.4%

Source: DMA Analysis of US Census Bureau Data.

Table 2: Non-Store Retail Economic Performance

Non-Store Retailers	1997	2002	2007 (Est'd)	97- 07 % Chg
Number of Firms	44,482	54,921	65,360	46.9%
Sales ($1,000)	$113,120,159	$172,864,966	$260,547,323	130.3%
Average Revenue ($1,000)	$2,543	$3,148	$3,752.0	47.5%
Employees	505,993	571,438	636,883	25.9%
Average Employees	11.4	10.4	9.7	-14.3%
Efficiency ($1000 Sales/Employee)	$223.6	$302.5	$409.1	83.0%

Source: DMA Analysis of US Census Bureau Data.

Table 3: BAT Reform Impact Estimates

	2008	2009	2012
Ad Spending Impact			
Baseline ($000)	$ 183,149	$ 193,493	$ 227,758
Less BAT Tax Burden	$ 183,904	$ 194,291	$ 228,698
Difference	$ 755	$ 798	$ 939
% Difference	0.4%		
Sales Impact			
Baseline ($000)	$ 2,158,634	$ 2,303,296	$ 2,791,406
Less BAT Tax Burden	$ 2,167,535	$ 2,312,793	$ 2,802,917
Difference	$ 8,901	$ 9,498	$ 11,511
Ad Employment Impact			
Baseline	1,660,930	1,698,161	1,811,815
Less Tax Sim 1	1,667,779	1,705,164	1,819,287
Difference	6,849	7,003	7,472
Seller Employment Impact			
Baseline	9,206,257	9,462,400	10,219,965
Less Tax Sim 1	9,244,220	9,501,418	10,262,108
Difference	37,963	39,018	42,143
Total Employment Impact			
Baseline	10,867,187	11,160,561	12,031,780
Less Tax Sim 1	10,911,999	11,206,582	12,081,395
Difference	44,812	46,021	49,615

Statement for the Record

of the

AMERICAN **BANKERS** ASSOCIATION

Committee on Small Business

U.S. House of Representatives

For the hearing

The Business Activity Tax: The Tax Burdens Felt by Small Businesses Engaged in Interstate Commerce

February 14, 2008

American Bankers Association, 1120 Connecticut Avenue NW, Washington, DC 20036

The American Bankers Association (ABA) appreciates the opportunity to submit comments to the House Small Business Committee on the growing burden of business activity taxes and the recent introduction of the Business Activity Tax Simplification Act (BATSA). The ABA strongly supports this bill and hopes that Congress will work quickly to pass this legislation.

The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

Today, banks of all sizes face the growing problem and difficulties associated with business activity taxes. These questionable levies greatly increase compliance and legal costs. Additionally, the inconsistency of their use is leading to a great deal of uncertainty that will ultimately cost consumers and our economy at large. ABA encourages Congress to pass BATSA to provide businesses with more certainty in regard to this issue. This statement explains our growing concerns about business activity taxes and presents the reasons for ABA's support of BATSA.

An increasing number of states have passed, or are considering, legislation that would lower the threshold of what constitutes "substantial nexus" for purposes of taxing a business' activity within the state. Nevertheless, there is no uniform definition or application of "substantial nexus" among the states. Therefore, each state applies its own nexus standard to determine when an out-of-state business that is operating within the state is required to pay income tax. There are no set rules or parameters for determining how a state would apply the nexus standard – it varies from state to state. In fact, in some states, the presence of even one customer within the state would establish the state's required nexus for applying its business income tax to an out-of-state business.

Healthy competition for customers helps ensure that customers receive the highest quality products at the best prices, but uncertainty in the area of state income tax increases compliance costs for businesses. The application of inconsistent standards subjects businesses to different treatments from state to state, with the result that many businesses now face litigation and other onerous business costs. These additional costs represent revenues that businesses could invest in areas, such as business innovation, improved customer service, or additional employees. Without business certainty, businesses may be forced to offer fewer products and services at higher costs, and some may actually cease doing business in states where additional tax burdens exist. The effect of this aggressive taxing of out-of-state businesses can have a negative impact on consumers in those states, reduced consumer access to credit and increased credit costs. This could have even broader negative effects on individual states' economies and, possibly, the economy of a larger region.

This lack of uniformity has a more devastating effect on smaller companies, such as community banks, because they do not possess the substantial resources required to comply with a proliferation of disparate state tax laws. There are more than 3,200 banks and savings associations with fewer than 25 employees. Many of these community banks operate near state borders and serve customers from more than one state. Additionally, many financial institutions now provide services to customers online, which allows more people nationwide to take advantage of increased competition and better services to fit their individual needs than ever before. Without a uniform standard, these institutions are finding themselves subject to different standards that result in undue costs and burdens.

An example of the complexity and burden associated with state income taxes is an ABA member that has operations (and, therefore, physical presence) in only four states, but is subjected to tax claims in 31 states. To avoid burdensome legal costs, this institution has chosen to pay these claims, which last year amounted to roughly $3 million. This $3 million could have been put to better use for customers, such as providing homeownership or small business loans. Instead, the institution was forced to use these resources to pay burdensome taxes in states where it has no physical presence.

The ABA is pleased that Representatives Rick Boucher and Bob Goodlatte have introduced the Business Activity Tax Simplification Act (BATSA) to address this issue of the lack of uniformity in the standard for taxing an out-of-state business's activity within a state. This bill provides a uniform definition for the standard to be employed by states in establishing whether an out-of state business should be subject to tax for activities conducted within the state, which will greatly help to streamline the out-of-state business activity tax within states and limit businesses' exposure to burdensome business activity taxes. The bill would require an actual physical presence in a state for the state to establish the necessary substantial nexus for imposing its tax on an out-of state business. Under the definition of physical presence, the bill provides a bright-line test that all states must use to determine whether a business's activity within the state should be subject to income taxes and additional paperwork. In addition to providing the much-needed certainty in this area, this bill would help limit businesses' exposure to unanticipated taxes, and thus reduce compliance and legal costs associated with frivolous nexus clams.

By providing necessary certainty, the enactment of BATSA will benefit not only businesses, but consumers who will receive competitive choices, options and prices to fit their individual needs.

ABA is grateful to Representative Boucher and Representative Goodlatte for introducing the Business Activity Tax Simplification Act in the 110th Congress and to Chairwoman Nydia Velazquez for holding a hearing on this important issue. We look forward to working with the Committee on this legislation.

For further details on ABA's positions on this issue, please contact Larry Seyfried by phone at (202) 663-5322, or e-mail at larrys@aba.com.

Statement
Of
The Federation of Tax Administrators
On the Topic of
Business Activity Taxes and Their Impact on Small Business
Before
The Committee on Small Business
United States House of Representatives

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The Federation of Tax Administrators (FTA) is an association of the tax administration agencies in each of the 50 states, the District of Columbia, Puerto Rico, and New York City. We appreciate the opportunity to present our views on legislation that would restrict the ability of states to impose business activity taxes.

FTA strongly opposes any legislation that would restrict a state's constitutional authority to tax entities engaged in "doing business" in the state. Specifically, FTA opposes the Business Activity Simplification Act (H.R. 5267) (BATSA) that was introduced Representatives Rick Boucher (D-Va.) and Bob Goodlatte (R-Va.) in the House of Representatives.

Background. Decisions by the United States Supreme Court allow a state to tax business activities within the state if there is a substantial nexus between a commercial entity doing business in the state and the taxing state. H.R. 5276 would require that an entity have certain limited types of physical presence in a state before it would be subject to a state's business activity taxes. The bill also substantially expands a 1959 law (P.L. 86-272) that protects certain solicitation activities from taxation by increasing the types of activities that are protected under the Act and expanding the range of taxes subject to P.L. 86-272. By so doing, the bill substantially narrows a state's authority to tax entities operating in the state, reverses years of judicial precedent and creates tax-planning opportunities, especially for large businesses to eliminate state taxation of revenues earned within a state.

- Business activity taxes (BATs) are levied by states for the privilege of doing business in or earning income within a state; they include state corporate income taxes, gross receipts taxes, business license taxes, franchise taxes, and business and occupation taxes. Importantly, it would apply a new restrictive standard to the recently enacted new business taxes in Michigan, Ohio and Texas.

- The legislation would impose the largest unfunded tax preemption mandate ever estimated by the U.S. Congressional Budget Office, a state revenue loss of $3 billion per year.

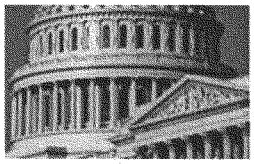
- While purporting to simplify business activity taxes by creating a "physical presence" standard, the legislation contains a number of conditions under which certain types of physical presence are to be ignored for purposes of determining whether an entity may be taxed by a state. The net effect is to constrain state tax bases, encourage tax planning and spawn significant litigation.

- This legislation represents a break from existing U.S. Supreme Court and state court precedents governing this area and will set off new rounds of litigation between businesses and states and local governments.

- The legislation would legalize business tax sheltering plans that larger business but not smaller in-state businesses can take advantage of by transferring intangible assets to holding companies incorporated in no or low tax states and otherwise structuring the affairs of a business so as to avoid tax.

- The legislation favors out-of-state businesses over in-state businesses. It would allow a large corporation that can conduct business online to go into a state electronically and exploit the market in that state with the services it may offer without being subject to taxes and that in-state businesses are required to pay.

Attached is White Paper in a Q&A format that discuss in detail what is being proposed and the reasons for FTA's opposition to the bill.



FTA White Paper

Federation of Tax Administrators
444 N. Capitol St., N.W., #348, Washington D.C., 20001 * (202) 624-5890

States Oppose

Business Activity Tax Restrictions

Contact: Marty Morris
(202) 302-7296

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States Oppose

Business Activity Tax Restrictions

1. Question: What is being proposed?

Answer: The Business Activity Simplification Act (S. 1726 and H.R. 5267) (BATSA) was introduced by Senators Charles Schumer (D-N.Y.) and Mike Crapo (R-Idaho) and Reps. Rick Boucher (D-VA.) and Bob Goodlatte (R-VA.). The bill requires that a business have certain types of physical presence in a state before it would be subject to a state's business activity taxes. The bill also substantially expands a 1959 law (P.L. 86-272) that protects certain solicitation activities from taxation by increasing the number and types of activities that are protected under the Act and expanding the range of taxes subject to the P.L. 86-272. By so doing, the bill substantially narrows a state's authority to tax entities operating in the state, reverses years of judicial precedent and creates tax-planning opportunities, especially for large businesses to eliminate state taxation of revenues earned within a state.

The Congressional Budget Office estimated that past bills that would result in the same type of substantive restrictions on state taxing authority would result in a $3 billion annual revenue loss. The National Governors Association estimates an annual range of lost state tax revenues from $4.7 billion to $8 billion, with a best single estimate of $6.6 billion.

2. Question: How are business activity taxes levied today?

Answer. States levy various forms of business activity taxes today. The most common is the corporation net income tax imposed in 44 states and D.C. Other types of business activity taxes that would presumably be affected by the bill include the Washington State Business and Occupation Tax, Ohio Commercial Activity Tax, Michigan Business Tax and Texas 'Margin Tax' (which are general business taxes levied on gross receipts (or a variant thereof) sourced to a state) as well as the New Hampshire Business Enterprise Tax (a value added tax.)[1]

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[1] BATSA defines a business activity tax as a "a net income tax" defined as the term is used in P.L. 86-272 as well as "any tax in the nature of a net income tax or tax measured by the amount of, or economic results of, business or related activity conducted in the State." Other taxes that would fall under the bill include the franchise/capital stock taxes levied in a number of states, the Delaware gross receipts tax, and certain other "doing business" taxes. These are of lesser importance from a revenue standpoint than the corporate income tax and other taxes enumerated above.

Under current law, a state must establish that a business has a sufficient connection with the state before it may exercise its jurisdiction to impose a business activity tax, and the tax imposed must bear some relation to the level of activity of the business in the state.[2] Over time, the U.S. Supreme Court has held that a company meets the jurisdictional standard of sufficient contacts ("substantial nexus" in the words of the Court) if it is "doing business" in the state or otherwise engaged in "establishing and maintaining a market" in the state. It has also held that the tax is fairly related to the level of activity in the state if the income of the company is divided among states in which the business is operating in a fashion that reasonably reflects the taxpayer's activity in the state.

Once jurisdiction to tax is established, state corporate income taxes generally operate as follows. The state tax base is federal taxable income of the taxpayer in all states, plus and minus certain modifications (e.g., to exclude certain income that states may not constitutionally tax.) The income from activities in all states is then "apportioned" or divided among the states in which the company operates according to a formula that usually compares the corporation's payroll, property and sales (the factors) in the state compared to the company's payroll, property and sales "everywhere" or in all states.[3] Once the income attributable to an individual state is determined, the state's rates, credits and other adjustments are applied to determine the final tax owed.

3. **Question:** How would BATSA change current law?

Answer. BATSA has two major components: (1) It significantly narrows state taxing jurisdiction by requiring that an entity must have one or more of certain specifically enumerated types of physical presence in a state before that state could impose a business activity tax on the entity[4]; and (2) It expands the reach and coverage of Public Law 86-272, a 1959 law intended to provide temporary restrictions on the ability of states to levy net income taxes on certain multistate businesses. The combination of the two changes would establish a framework in federal law that allows large, multi-state businesses to engage in tax structuring and planning and enables them to avoid a significant part of their tax liabilities.

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[2] See *Complete Auto Transit v. Brady* 430 U.S. 274 (1977). This case sets out two other tests for state taxes that do not come into play in the context of BATSA.

[3] Gross receipts taxes are subject to the same "substantial nexus" requirement as corporate income taxes, but they are not apportioned according to a formula. Instead, the various transactions to which the tax is applied are "sourced" to a single jurisdiction according to certain rules, and that determines which state has the right to tax the transaction, provided the jurisdictional standard is met. Gross receipts and other non-net income taxes are specifically not subject to P.L. 86-272 today.

[4] It accomplishes this by first establishing a physical presence requirement and then expanding the list of activities "protected" (i.e., to be disregarded in determining whether a company has a substantial nexus with the state) under P.L. 86-272.

Despite many statements of BATSA proponents to the contrary, the U.S. Supreme Court has never held that a physical presence is required to meet the "substantial nexus" requirement for imposition of a state business activity tax. In fact, it specifically said it was not establishing such a requirement in the 1992 *Quill* case. The BATSA legislation would for the first time prohibit a state from imposing a business activity tax on a company doing business in the state unless the company had specifically enumerated types of physical presence in the state.

BATSA also would negate U.S. Supreme Court decisions that found a company meets the "substantial nexus" requirement by virtue of activities performed on its behalf by others. Specifically, the Court's 1987 decision in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue* would be reversed. In *Tyler Pipe*, the Supreme Court upheld the imposition of Washington's business and occupation tax based on the use of an in-state sales representative, characterized as an independent contractor, to establish and maintain a market in the state. BATSA provides that using the services of a representative to establish or maintain a market in a state would constitute a sufficient physical presence only if such representative were an "agent" of the entity and only "if such agent does not perform business services in the State for any other person...." BATSA effectively knocks the legs out from under *Tyler Pipe* by allowing a company to avoid taxation in a state simply by using someone else to do its work in the state, as long as that contractor performs services for at least one other entity. The contractor may, in fact, be a wholly owned subsidiary of the taxpayer, so long as it performs work for someone else.

Finally, the bill expands the reach of Public Law 86-272 – which now prohibits states from imposing a net income tax on an entity whose only contact with the state consists of the solicitation of sales of tangible personal property – to include all business activity taxes (gross receipts, value added, franchise, etc.,) and to broaden the scope of protected activities to include all sales, including sales of other than tangible personal property, such as intangible property and services. It also extends the list of activities protected under P.L. 86-272 to include the "coverage of events or other gathering of information" in the state if the information is used or disseminated from a point outside the state and activities directly related to the actual or potential purchase of goods and services in the state, if the purchase is approved outside the state.

Together, these provisions provide a road map that a multi-state company can use to structure its business operations so as to avoid any state business activity tax liability. That is, to the extent that a company can insure that its activities within a state are performed by someone else, do not step over the physical presence boundaries of BATSA or exceed the scope of protected activities under the expanded P.L. 86-272, a company can eliminate or reduce its tax liability in that state. Examples of the manner in which this can be accomplished are presented below.

4. **Question:** Specifically, how will companies be able to avoid state taxes under BATSA?

Answer: BATSA requires that a company must have certain types of physical presence in a state before it may be subjected to a state business activity tax. As a general matter, therefore, to the degree that a company can limit its activities to those that do not cross the lines of BATSA and that fall within the expanded protections of P.L. 86-272, it will be shielded from taxation regardless of how much income it might derive from that state. In addition, a number of states have (at the urging of the business community) adopted a "single sales factor" system of apportionment providing, in effect, that the percentage of a company's income that will be subject to tax in a state will be based only on the percentage of sales in that state compared to the company's sales in all states.[5]

There are two basic methods of using BATSA to avoid state taxes. First a company can avoid tax in a single sales factor state by locating its physical assets in that state, but making sales into the state through another company. Second, BATSA would allow a company to avoid tax in all states into which it is making sales as long as it had no physical presence in those states or it confined its physical activities to the activities protected under the expanded P.L. 86-272.

By establishing the tax planning opportunities so clearly in Federal law, BATSA may effectively require a company to begin engaging in certain planning activities that it currently considers too risky or inappropriate out of a fiduciary duty to shareholders. Here are several specific examples of avoidance opportunities that BATSA condones.

Intangible Holding Company. A strategy used by a number of companies is to create a holding company that is the wholly owned subsidiary of a major retailer to own the intangibles (patents, trademarks, service marks, etc.) of the retailer. Those intangibles are then licensed to the retail operations of the company, and each retail store is then required to pay a license fee (often just about equivalent to the profit earned by the store) to the intangible holding company that is customarily located in a state (e.g., Delaware or Nevada) that does not tax income from the licensing of intangibles. The retail stores take a deduction as a current expense for the licensing fee paid to the holding company. This transaction has the effect of shifting income from the state where it is earned (i.e., where the stores are) to a state where the income is not taxable – even though the holding company and the retail stores are all part of one corporate group and the holding company commonly has little in the way of actual operations.

Currently, this is considered risky tax planning. Many companies do not engage in such arrangements because a number of states have had assessments against such

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[5] Traditionally, states assigned equal weight to each of the three apportionment factors – property, payroll and sales. Recently, states have deviated from the traditional three-factor formula to provide greater weight to the sales factor. At the present time, 11 states employ (or allow on an optional basis) a single factor (sales) formula (i.e., sales are apportioned among the states based solely on the proportion of a company's sales in the state), 26 states employ a formula that has three factors but super-weight the sales factor, and 9 states use the traditional equally-weighted three factor formula.

holding companies affirmed by the courts."[6] If BATSA becomes law, a state would be prohibited from taxing the holding company to which the income was shifted because the holding company would not have any of the specifically enumerated types of physical presence in the state. BATSA would prevent states where the retail stores are located from taxing the holding company even though the income came from the retail operations in that state. The physical presence rule in BATSA would likely require many more companies to use an intangible holding company structure to minimize their taxes because of the fiduciary duty they owe to their shareholders.

No Physical Presence Business Operations. Larger businesses in certain industries are particularly well suited to conducting business in high volumes in a state without having a physical presence of any sort there. As a result, they will be able to avoid state taxation if BATSA is enacted. Every service a bank offers – including savings accounts, loans, and investment services – can be offered without any physical presence in a state. Under BATSA, large banks will be able to add to their economies of scale advantages of local banks by operating tax free in many states even if they do hundreds of millions of dollars of business in a state. In fact, it is precisely this type of financial services operation (credit card issuance and servicing) that was carried on without a physical presence in the state and that was found to constitute a sufficient nexus in the *MBNA* case in West Virginia.[7] BATSA would overturn that case and similar statutes in several other states that apply an economic presence test to financial institutions.

Entity Isolation – Manufacturing. The following example shows how a manufacturer (and many other types of firms) can divide its activities into separate entities each of which is responsible for part of production/selling process and avoid tax on much of its income. Assume a manufacturer has all its production facilities in State A, but sells all its products into other states through sales personnel whose activities are confined to those protected by P.L. 86-272, and that any other activities are conducted by contractors of the manufacturer who also perform such services for another person. Finally, assume that State A uses a single sales factor for apportioning income for tax purposes. In this scenario, the manufacturer would not owe tax to State A because it has no sales there. Neither will it owe tax to any other state since its activities are protected

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[6] Those cases include, but are not limited to: *Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07) (franchise and corporate net income taxes); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), cert. denied, 114 S.Ct. 550 (1993) (income tax); *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 (U.S., 2003) (income tax); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. Ct. App. 2001), cert. denied, 122 S.Ct. 1915 (2002) (business and occupation tax); *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21,140 (N.M. Ct. App. 2001), appeal pending (income tax); 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) (replacement income tax).

[7] See *Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07).

by P.L. 86-272 or are performed by contractors whose activities cannot be attributed to the manufacturer under BATSA.

Entity Isolation – Financial Services Scenario. Another strategy under BATSA would be to divide an integrated operation into separate companies – even though commonly owned and directed – to shield the operations of one from taxation in a state. Assume, for example, a State Z financial services company A breaks itself into companies B and C, which remain in State Z, as well as broker D, which is located in another state. Broker D services the State Z customers of companies B and C via Internet, mail or telephone as well as regularly interacting with B and C. Income earned by broker D on sales of financial services to State Z customers will no longer be taxable by State Z because broker D – in and of itself – does not have a physical presence in State Z. Currently, states could pursue taxation of D based on activities that B and C may perform on its behalf as well as its economic exploitation of the State Z market. BATSA prohibits the taxation of Broker D because it does not have the requisite physical presence, and the earnings of broker D would go untaxed in State Z where the income was earned.

Using a Contractor. Another simple tax avoidance strategy under a BATSA regime involves the use of contractors in a state to perform activities necessary for a seller to maintain a market in the state. Assume, for example, an out-of-state retailer of computers or other electronic devices markets its products into a state via the Internet, sales people operating within the confines of P.L. 86-272, and other direct sales methods. The sale of computers and electronic devices includes warranty contracts. The out-of-state retailer contracts with an independent contractor to provide the warranty service to its customers. The independent contractor provides similar services to other out-of-state retailers, all of which could be affiliates of one another. Under BATSA, the out-of-state retailer would not be subject to a business activity tax in the state into which it sold the computer because the activities of the contractor (even though essential to being able to sell its computers) could not be attributed to the seller – even if it used in-state sales personnel as long as they stayed within the confines of P.L. 86-272.

5. Question: What is the financial impact of BATSA?[8]

Answer. A cost estimate performed by the Congressional Budget Office for H.R. 1956, the "Business Activity Tax Simplification Act of 2005," dated July 11, 2006, stated:

> 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

[8] While the studies cited below were based on prior versions of BATSA, the effects of the bill on state tax structures is still very much the same. The estimates are considered reliable for the current versions as well.

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.

The National Governors Association's September 2005 study, "Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States," provided the following estimate:

> If H.R. 1956 is enacted the estimated revenue impact in fiscal year 2007, for the 34 states that have responded to the survey would range from approximately $3.3 billion, or approximately 8.2 percent of projected business activity tax revenues in that year to $5.5 billion, or approximately 12.7 percent of projected business activity tax revenues. The "best" estimate of the impact is approximately $4.6 billion, or approximately 10.4 percent of projected business activity tax revenues in that year. Applying these proportionate revenue impacts to all states, the projected revenue impact in fiscal 2007 would range from $4.7 billion to $8.0 billion; the "best" estimate would be $6.6 billion. The estimated revenue impacts would range from 8.2 percent of projected business activity tax revenue in fiscal year 2007 to 13.8 percent; the "best" estimate would be 11.4 percent

6. Question: BATSA proponents say that a physical presence is currently required before a state may impose a business activity tax. Is that correct?

Answer. The current "substantial nexus" standard for business activity taxes is not "physical presence" as the BATSA proponents contend. The current standard governing imposition of a business activity tax on an entity operating in interstate commerce is an economic presence in the state. In a 1944 decision, *International Harvester Co. v. Wisconsin Department of Taxation*, the U.S. Supreme Court upheld a Wisconsin dividend tax imposed on nonresident shareholders, stating that personal presence within the state was not essential to the constitutional levy of the tax, and no subsequent decision has held otherwise for purposes of a business activity tax.[9]

In its most recent seminal state tax "nexus" case of *Quill Corp. v. North Dakota* (1992), the Court addressed head-on the issue of the nexus standard for sales and use taxes. It held that a state could not require a seller that did not have a physical presence

[9] The *International Harvester* decision, like most decisions regarding the nexus standard for business activity taxes, admittedly predates modern Commerce Clause jurisprudence that requires a "substantial nexus." It focuses primarily on due process considerations (requiring minimum contacts, something less than a "substantial nexus.") Nonetheless, the essential point is that the Supreme Court has never held that a physical presence was required to establish jurisdiction for purposes of imposing a business activity tax. See also *Whitney v. Graves*, 57 S. Ct. 237 (1937), upholding the authority of a state to impose tax on profits from the sale by a nonresident of a membership in the New York Stock Exchange even though the company did not have an office or did business in N.Y., but had its orders executed through New York-based members of the Exchange.

in the state to collect sales or use taxes on goods and services sold into a state. *Twice in that opinion, however, the Court noted that it had not applied the physical presence requirement outside the sales and use tax arena and was not so doing in Quill.*[10] Since the Court has never applied the onerous physical presence nexus standard to business activity taxes, the jurisdictional standard for applying these taxes must be less than physical presence, i.e., an economic presence.

The U.S. Supreme Court language supports a large number of state court decisions have held that an economic presence in the state is sufficient to provide the state with jurisdiction to impose a business activity tax on an entity operating in interstate commerce.[11] Most recently, the West Virginia Supreme Court held that the state could impose its income tax on a bank that had numerous credit card holders (but no physical presence) in the state because of its "substantial economic activity" in the state.[12]

7. **Question:** How does BATSA expand P.L. 86-272, and what issues does that create?

Answer. Currently, P.L. 86-272 prohibits states only from imposing a net income tax on income derived in the taxing state by an entity whose only business activities in the state consist of the solicitation of orders for sales of tangible personal property. BATSA would expand P.L. 86-272 by: (1) expanding its protections to the solicitation of all types of sales, including sales of services and intangible property; (2) extending the list of activities protected to include the "coverage of events or other gathering of information" in the state if the information is used or disseminated from a point outside the state and activities directly related to the actual or potential purchase of goods and services in a state; and (3) broadening the types of taxes covered to include not only net income taxes, but also any tax in the nature of a net income tax or a tax measured by the amount of, or economic results of, business or related activity conducted in the State. Presumably, this expansion would include the Washington State business and occupation tax, the new Texas "margin tax," the Ohio commercial activity tax, the Michigan Business Tax and a host of franchise/capital stock taxes under the umbrella of P.L. 86-272; these taxes are not covered under current law.

P.L. 86-272 was passed as an emergency, temporary measure in the wake of the U.S. Supreme Court decision in *Northwest States Portland Cement v. Minnesota,* 358

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

[11] See Footnote 6 above.

[12] See *Tax Comm'r of the State of West Virginia v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.V. 2006), *cert. denied, FIA Card Services, N.A. v. Tax Commissioner of West Virginia*, 127 S.Ct. 2997 (U.S., 6/18/07).

U.S. 450 (1959), where the Court held that a state could impose an income tax on a company by virtue of the activities of salespersons operating in the state. The intent of the Act was to temporarily constrain state taxing jurisdiction over companies operating in the state while states and the business community worked to better develop corporate tax rules.

P.L. 86-272, however, has never been repealed or modified, despite the further development of state income taxes. It has become, instead, a tool that some taxpayers use to minimize their state tax liabilities by structuring their organizations and transaction so as to limit their contacts with some states to those protected by the Act, even though they may have a substantial physical presence and sales in the state.

Expanding P.L. 86-272 to other types of taxes and to sales of intangibles and services is unwarranted, particularly in the context of a bill purporting to establish a physical presence standard for business activity taxes. An expanded P.L. 86-272 would allow a company to have an unlimited number of sales people and contractors and an unlimited number of vehicles in a state making sales for an unlimited period of time and not be subject to a business activity tax. If physical presence is the appropriate nexus standard for business activity taxes, as the proponents of the bill argue, then it ought to be a pure standard and not one modified by P.L. 86-272. If a physical presence standard is adopted, P.L. 86-272 should be repealed – not expanded.

8. Question: What is does the "limited or transient" language in BATSA do?

Answer: The "de minimis" provision of BATSA provides that "the term 'physical presence' shall not include … presence in a State to conduct limited or transient business activity." With the terms "limited" and "transient" neither defined in the bill nor possessed of any accepted meanings in tax law, courts would look to dictionary definitions for their meaning. "Limited" is defined in Black's Law Dictionary as: "Restricted; bounded; prescribed. Confined within positive bounds; restricted in duration, extent, or scope." "Transient" is defined in Black's as "Passing across, as from one thing or person to another; passing with time of short duration; not permanent; not lasting."

While, at first blush, it might appear that the term "limited or transient" conveys the "de minimis" meanings that it is designated in the bill to have – perhaps with a meaning such as "not indefinite" – the language does not work that way. That is, the words are not synonyms, as "transient" has a temporal component that "limited" does not have, so that, in applying the definitions noted above with the disjunctive "or," a company's activity could be permanent but limited in scope, or unlimited in scope but not permanent, and still be protected from taxation as "de minimis." Therefore, for example, a corporation, whose charter or application to conduct business in the state indicates that it will engage only in banking activities and nothing else (so that its activities are "limited," as "restricted in … scope"), could be protected from taxation even if in the state permanently, as could a corporation whose charter or application indicates that it

will engage in every activity in the state that a corporation may legally perform, but only do so for ten years (so that its activities are "transient," as "not permanent").

9. Question: What are the consequences of adopting a physical presence standard with numerous exceptions allowing for a physical presence without incurring a tax liability?

A physical presence standard as structured in BATSA favors big business over small business. While there is nothing in the language of BATSA that specifically limits its protections to larger businesses, they will, as a practical matter, have more opportunities available to them to engage in the tax-planning activities discussed earlier. 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. There must be at least the appearance of a business purpose for setting up the second corporation. That appearance is more available to larger corporations that will, for example, have trademarks to put into the other entity and then license back to the operating corporation. Mom-and-pop operations are less likely to have those options and less likely to have the resources to pay for the tax-planning services necessary to develop them.

A physical presence standard as structured in BATSA favors out-of-state business over in-state business, employment and investment. BATSA also favors out-of-state businesses over in-state businesses. For those businesses like banks that can operation without local offices, they will be encouraged to keep from opening offices and close any that they have. Under BATSA, while a smaller local bank with an office in the state will have to pay all of the state's taxes, an out-of-state bank operating electronically will be free of taxes imposed by the state where it has a substantial customer base. A physical presence standard discourages an interstate business from investing in the communities in which it does business, by rewarding out-of-state sellers for not bringing jobs or facilities into the communities from which it is deriving profits with the competitive advantage of not having to pay the communities' business activity taxes that the in-state businesses have to pay.

A physical presence standard for state business activity taxes contradicts other activity by Congress, and the evolution of commerce in the electronic age. As noted above, BATSA not only authorizes and promotes, but could compel for fiduciary reasons, what is now considered risky tax planning that makes use of a variety of means of sheltering income earned in a state. This effect directly contradicts the current efforts of Congress to eliminate a variety of tax-shelter activities for federal income tax purposes. In the passage below, Sen. Carl Levin, Chairman of the Senate Permanent Committee on Investigations, deplores the use of an offshore intangible holding company (much like the example outlined in Question 4) as an inappropriate federal tax dodge. Yet, this is exactly the type of tax shelter that BATSA would legitimize at the state level.

> Here's just one simplified example of the gimmicks being used by corporations to transfer taxable income from the United States to tax havens to escape taxation.

Suppose a profitable U.S. corporation establishes a shell corporation in a tax haven. The shell corporation has no office or employees, just a mailbox address. The U.S. parent transfers a valuable patent to the shell corporation. Then, the U.S. parent and all of its subsidiaries begin to pay a hefty fee to the shell corporation for use of the patent, reducing its U.S. income through deducting the patent fees and thus shifting taxable income out of the United States to the shell corporation. The shell corporation declares a portion of the fees as profit, but pays no U.S. tax since it is a tax haven resident. The icing on the cake is that the shell corporation can then "lend" the income it has accumulated from the fees back to the U.S. parent for its use. The parent, in turn, pays "interest" on the "loans" to the shell corporation, shifting still more taxable income out of the United States to the tax haven. This example highlights just a few of the tax haven ploys being used by some U.S. corporations to escape paying their fair share of taxes here at home.

BATSA also contradicts Congress's consideration of bills that would expand the authority of states to require collection of sales and use taxes by interstate sellers as part of the effort to deal with the impact of remote sales on states. Twenty states have created a voluntary sales and use tax regime based on a simplified, more uniform sales tax system. The program went into effect in October 2005. The next step is passage of a federal law that would require remote sellers to collect sales and use tax on goods and services they sell into states that are members of the Streamlined Sales Tax Agreement. In passing such legislation, Congress would be undoing the current physical presence requirement for purposes of the only taxes for which that standard is required, while BATSA would impose a nexus standard narrower than physical presence on taxes for which the physical presence standard is not now the law.

10. Question: If physical presence is the standard for sales and use tax nexus, why shouldn't the physical presence requirement be applied to business activity taxes?

Answer. As noted above, at a time when Congress is considering removing the physical presence requirement from the only taxes to which it has ever been applied by the U.S. Supreme Court, BATSA seeks to impose that physical presence requirement on taxes to which the Supreme Court has said it does not apply. But, the problem with BATSA is more than just the contradiction with the philosophy behind Congressional action in the sales and use tax area which reflects the movement of commerce into the electronic age; it's also that none of the factors that motivated the Supreme Court to reluctantly affirm the physical presence requirement for sales and use tax in the *Quill* decision – *stare decisis*, the mail order industry's development around a reliance on that previous decision (*Bellas Hess*), and the complexity of state sales and use tax laws and requirements – exist with business activity taxes.

There has obviously been no chance for any reliance on any physical presence requirement for business activity taxes since the Court has never imposed such a requirement on taxes other than sales and use taxes. The complexity issue presented by

the various state sales and use taxes is not presented by business activity taxes that are inherently simpler to comply with. Most corporate income taxes are based on federal taxable income, generally with modest variations from that figure. Other business activity taxes are based on gross sales figures or figures already compiled for other regulatory purposes, such as utilities' gross receipts taxes.

Therefore, while the bills dealing with sales and use tax of remote sales would level the playing field between in-state businesses and out-of-state businesses exploiting the in-state market, BATSA would do exactly the opposite. It would allow out-of-state businesses to exploit an in-state market without the burden of that state's taxes, a burden the in-state businesses have to bear.

11. Question. What arguments do BATSA proponents offer in support of the bill?

Assertion: The bill is necessary to establish a "bright line" so that a company will know when it is subject to tax.

Response: The physical presence requirements in the bill are far from a "bright line." BATSA does not require simply that a company have a physical presence in the state in order to be subject to the state's tax jurisdiction. Instead, a company must have certain types of physical presence that are not protected by the expanded P.L. 86-272 and that do not fall within the *de minimis* exceptions of BATSA or the "limited or transient" exception in BATSA. The various limitations and carve-outs from physical presence will create confusion, uncertainty and litigation as companies attempt to move up to the line of BATSA, but not cross over it. A simple physical presence standard and a repeal of P.L. 86-272 would be a bright line; BATSA is not a bright line.

Assertion: BATSA is designed to protect small businesses from being subject to tax in every state in which it might make a sale.

Response: The physical presence requirements of BATSA are not designed to assist small businesses. They are, instead, intended to provide opportunities for large companies to structure and plan to avoid state taxes. The U.S. Constitution and due process considerations require more than a single sale before a state could exercise its tax jurisdiction. States are willing to work with the business community to structure *de minimis* standards that will provide clarity for small businesses. BATSA does not provide an appropriate framework for such a standard.

Assertion: Companies with no physical presence in a state do not use services in the state and should not be subject to tax.

Response: The assertion that an out-of-state seller derives no benefits from a state in which it has no physical presence (and thus should not be subject to tax) is "indefensible." Two noted scholars in the field of state and local taxation responded to that argument as follows:

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 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.[13]

Assertion: Taxing entities that have only a physical presence in a state amounts to "taxation without representation."

Response: While "no taxation without representation" is a catchy slogan, it is not one of the enumerated rights embodied in the U.S. Constitution. The Supreme Court has long upheld the right of states to impose taxes on nonresidents (individuals and corporations) doing business in a state. Moreover, the companies supporting BATSA have found plenty of avenues for making their desires known to state elected and appointed officials. Most importantly, the issue here is one of equal taxation of in-state businesses and out-of-state businesses. If that is achieved, the in-state representatives will effectively represent the interests of out-of-state businesses.[14]

12. Question: Are there principles of federalism that should be considered here?

Answer: Enactment of BATSA would violate established principles of federalism. Principles of federalism dictate that the federal government should not encroach on functions of state and local governments so integral to their sovereignty as the powers to tax without a clearly demonstrated need to do so. The few stories that have been offered purporting to show overreaching by state tax agencies involve only *de minimis* situations – i.e., taxpayers with limited contacts with a state being subjected to that state's taxes. By addressing an asserted problem of companies with relatively minor contacts being taxed with a bill that would reduce state revenues by billions of dollars annually is like swatting a fly with a sledgehammer – with all the corresponding damage that metaphor implies.

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[13] Charles McLure and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, February 26, 2004.

[14] For a more complete discussion, see McLure and Hellerstein, op. cit., p. 735.

In recent years, state and local governments consistently have demonstrated a willingness to work with the business community to develop solutions to problems that have been demonstrated to require Congressional attention. For example, they worked with the telecommunications industry to produce the Mobile Telecommunications Sourcing Act in 2000 to address the problem of determining which taxing jurisdiction should be able to tax wireless telephone service. State and local governments are currently working with parts of the business community to simplify sales and use taxes as part of the Streamlined Sales Tax Project, with an eye toward leveling the playing field for all types of sellers with expanded authority to require tax collection.

If the business community were to demonstrate a significant problem, such as complexity in business activity taxes or over-aggressiveness on the part of states in imposing such taxes on businesses with only a *de minimis* presence in the state, the state and local governments would be more than willing to work on streamlining those taxes and developing uniform *de minimis* standards. An approach that would accomplish that aim is identified in Question 12 below.

Whether or not the bill falls within Congress's powers under the Commerce Clause, this is not an appropriate preemption. States generally oppose the federal government's preemption of their options to tax, but have not done so dogmatically. Congress is considering imposing draconian measures on states where there has not even been a serious problem demonstrated to exist. That is not consistent with how Congress has traditionally dealt with state taxation in our federal system.

13. Question: Do the opponents of BATSA have an alternative to offer?

Answer. If Congress considers it important to establish a "bright line" nexus standard in Federal law, it should consider a proposal developed by the Multistate Tax Commission called the "factor-presence standard." Under the factor-presence standard, a state would have jurisdiction to impose a business activity tax on a company if the company had more than $50,000 in property, $50,000 in payroll, or $500,000 in sales in the state, or 25 percent of total property, total payroll or total sales in the state. In other words, if a company has a substantial economic presence in a state (as measured by any of the factors commonly used to apportion income for income tax purposes), it would be subject to the business activity tax of the state.[15]

The factor-presence standard has several advantages in comparison to BATSA:

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[15] For a more complete description of the standard, see Multistate Tax Commission Policy Statement 02-02, as amended October 17, 2002, "Ensuring the Equity, Integrity and Viability of State Income Tax Systems"

- It is truly a "bright line" in that the determinants of when a company would be subject to a business activity tax are clear, easily understand, quantifiable and straightforward.
- It would reduce litigation and compliance costs for multi-state taxpayers and tax administration agencies alike.
- It would eliminate the ability to engage in tax planning, thus effectively leveling the playing field among companies and improving the equity of state business activity taxes.
- It is consistent with the way business is operated today, and it is consistent with the operation of state income taxes since it is based on the same factors used to apportion income under state income taxes.

14. Are there other commentators that have offered thoughts on BATSA and the issue of nexus for business activity taxes?

Answer: The New York State Bar Tax Section recently wrote to certain Congressional leaders offering its views on BATSA. Among the key points made in the letter are: (1) If Congress is to establish a bright line nexus standard in federal law, that standard "should take into account 'economic presence' [of an entity in the state] rather than being limited to a pure "physical presence" test" and should include a de minimis threshold to reduce administrative burdens; (2) A physical presence standard would promote income shifting and tax planning by businesses; (3) U.S. Supreme Court decisions do not make clear that physical presence in a state is necessary to establish nexus for business activity purposes; (4) BATSA, as introduced, is "ambiguous" and in many ways unclear; and (5) Attempting to develop a nexus standard by amending a 50-year old law is inappropriate and ineffective.

Statement of
Jerald Otchis
Vice President Finance and Administration
Bobrick Washroom Equipment, Inc.

On Behalf of the
National Association of Manufacturers

Before the
Committee on Small Business
U.S. House of Representatives

Hearing on
Business Activity Taxes and their Impact on Small Businesses

February 14, 2008

Ms. Chairwoman and Members of the Committee,

I am pleased to have the opportunity to submit this statement on behalf of the National Association of Manufacturers (NAM) for the record of the February 14, 2008, House Small Business Committee hearing on the impact of business activity taxes (BATs) on small businesses.

The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. My name is Jerald Otchis and I serve as Vice President Finance and Administration at Bobrick Washroom Equipment, Inc. Bobrick, a member of the NAM, is the leading company in the world in the design, manufacture and distribution of washroom accessories and toilet partitions for the non-residential construction market. The company celebrated its 100th anniversary in 2006.

The Business Activity Tax Simplification Act

NAM members strongly support H.R. 5267, the Business Activity Tax Simplification Act (BATSA) introduced last week by House Judiciary Committee members Rick Boucher (D-VA) and Bob Goodlatte (R-VA). By establishing a bright-line physical presence test for when a state can tax out-of-state companies, BATSA will prevent the arbitrary state taxation of interstate commerce without jeopardizing the ability of states to legitimately tax companies with operations in the state.

Some states currently assess business activity taxes (BAT), e.g. income, franchise, or gross receipts taxes, on out-of-state manufacturers and other businesses that do not have any employees or property in the state. This arbitrary taxation of out-of-state businesses interferes with interstate commerce. Lawmakers last addressed this issue in 1959, when they clarified that a state cannot impose income taxes on an out-of-state company if the company's only contact with the state is to solicit orders for sales of tangible goods. BATSA would update the current "safe harbor" for soliciting sales of tangible goods to sales of intangible goods and services.

One Company's Experience

Bobrick's headquarters, including manufacturing and distribution facilities, are located in North Hollywood, California. In addition, Bobrick has factories and warehouses in Colorado, New York, Oklahoma, Tennessee, and Toronto, Canada. The company, which employs more than 500 people, has subsidiaries in Australia and England. Bobrick manufactures more than 70 percent of its products in the United States and exports more than $25,000,000 of U.S.-made products each year.

Our products are sold in all fifty states to independent distributors who generally act as installing subcontractors to the general contractor constructing the building. All orders for product are sent to a Bobrick facility and shipped using common carriers.

Bobrick does not contest our responsibility to pay business activity and other taxes in the five states where we have facilities—California, Colorado, New York, Oklahoma, Tennessee. At the same time, the company has experienced first-hand attempts to impose business activity taxes on Bobrick by states where we do not deliver with company trucks, install or repair our products or have employees, offices, repair facilities, or bank accounts. Our efforts to fight these unfair assessments have consumed an enormous amount of time and valuable company financial resources, company dollars that could have been better spent on business expansion, job creation, and innovation.

In the 26 years I have been employed by Bobrick, we have had requests from more than ten states asking us to complete a questionnaire, consisting of fifteen to forty questions, to determine whether we have sufficient physical presence to constitute nexus with the state and thus be subject to the state's business activity taxes.

There is no single litmus question for determining nexus for purposes of imposing business activity taxes on out-of-state businesses, but rather the nexus decision should be based on a preponderance of facts and circumstances. In my experience, Bobrick generally has been able to answer most questions about presence in the negative and there have been no further inquiries from the state.

Occasionally, however, a question is phrased in such a way that a "no" answer is not appropriate. For example, the compound question by the state of Texas is worded to include employees, agents, or representatives who sell, solicit, or promote products in the state. Because

of the way the question is worded, the state inevitably asserts nexus, which is what happened in our case. We currently are appealing the Texas decision on nexus, an effort that already has cost us well over $100,000 for attorneys and consultants as well as a significant amount of internal staff time.

Furthermore, based on Bobrick's experience and the experience of other NAM members, this arbitrary and discriminatory state taxation falls disproportionately on small and medium size companies.

When my company was first challenged by the state of Texas, we asked other small and medium size companies that are members of the NAM about their experiences. Several NAM member companies also had been contacted by the state of Texas. While they felt they were not subject to Texas business activity taxes, the amount of taxes involved was small in comparison to the cost of challenging Texas' position, making it less costly for the company to pay the taxes. As a result, while it is likely that states may not win on imposing business activity taxes if challenged, most companies can not justify the cost of a challenge. This situation is blatantly unfair and particularly burdensome for small and medium size companies that do not have in-house legal departments to fight such arbitrary state taxation.

Furthermore, with more and more states taking an aggressive stance in imposing arbitrary business activity taxes on out-of-state companies, this additional taxation increases the domestic effective tax rates for U.S.-based companies, making it harder for these companies to compete globally.

Summary

The NAM strongly supports enactment of BATSA, which would establish a bright-line, physical presence test to determine when a state can levy income, franchise, gross receipts and other business activity taxes on out-of-state companies engaged in interstate commerce. By updating current law, BATSA would prevent a state from imposing business activity taxes on an out-of-state company if the company's only contact with the state is to solicit sales of tangible and intangible goods and services. Companies without a physical presence in a state would not be subject to business activity taxes simply because they have worldwide customers.

The legislation also would clarify that a state should not impose a business activity tax unless that state provides benefits or protections to the taxpayer. At the same time, it would reduce widespread litigation associated with the current climate of uncertainty that inhibits business expansion and innovation. Businesses of all sizes need the certainty of a "uniform state taxation nexus standard;" i.e. the minimum amount of activity a business must conduct in a particular state before it becomes subject to taxation in that state.

Thank you in advance for supporting this important legislation. Bobrick, as well as companies of all sizes—particularly small manufacturers—would benefit from the clarity and certainty provided by this important legislation.

Supplemental Sheet

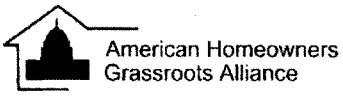
Statement by:

Jerald Otchis
Vice President Finance and Administration
Bobrick Washroom Equipment, Inc.
11611 Hart Street
North Hollywood, CA 91605-5882
Phone: (818) 503-1603

On Behalf of:

National Association of Manufacturers
1331 Pennsylvania Ave., N.W.
Suite 600 North
Washington, D.C. 20004-1790
Phone: (202) 637-3000

NAM contact: Monica McGuire, (202) 637-3076, mmcguire@nam.org



6776 Little Falls Road, Arlington, VA 22213
703-536-7776
AHGA@americanhomeowners.org
www.americanhomeowners.org

Defending the Interests of 75 Million U.S. Homeowners

Testimony

of the

The American Homeowners Grassroots Alliance

Submitted to the

House Small Business Committee

Hearing on

Business Activity Tax and Its Impact on Small Business

February 14, 2008

The American Homeowners Grassroots Alliance (AHGA) commends the House Small Business Committee for holding this hearing on the business activity tax. AHGA is an independent consumer advocacy organization which focuses on policy issues that have a significant economic impact on the nation's 75 million homeowners.

One of the biggest shifts in the small business marketplace is in workplace locations, which are rapidly moving to homes. According to IDC, a national research firm, there are between 34.3 million and 36.6 million home office households in the United States alone. At least 18 million are home-based businesses according to U.S. Census figures. They include millions of service businesses such as website designers and other consultants, as well as Internet-centric businesses, such as the millions of eBay Power Sellers who derive all or most of their income from Internet commerce. The balance are telecommuting employees of businesses of all sizes or governments at all levels. A recent survey of members of the American Institute of Architects revealed that home offices are the most popular special function room of home buyers for the third year in a row.

The use of economic nexus theories to justify imposing income and/or franchise taxes on non-resident businesses poses a significant challenge to the growing number of home based businesses. More than a dozen states have enacted laws or regulations establishing an economic nexus without a physical presence and others have effectively established the same policies through administrative or judicial decisions. It is obviously beyond the physical capability of home-based micro-businesses to keep up with and comply with such laws. These laws also adversely affect the millions of other homeowners who are the customers of those companies.

In addition, the growing expansion of ill-considered business activity taxes is undermining substantial benefits resulting from the growth of home-based businesses:

1. The slowdown in the growth of home-based businesses and telecommuting resulting from the expansion of BAT/Nexus would undermine the environmental and economic benefits of teleworking. Because they do not drive to work these homeowners are helping to reduce rush hour traffic jams and defer the needs for state and federal transportation infrastructure investments, both for expansion and maintenance. The shift to home-based teleworking is helping reduce environmental pollution and global warming. A recent study by TIAX LLC determined that a full time telecommuter who lives 22 miles from his business would save 320 gallons of gasoline and reduce CO_2 emissions by 4.5 to 6 tons per year. At $3.00 per gallon gasoline prices they would also save homeowners about $1,000 in cash, not including savings in automobile maintenance costs and depreciation resulting from the extra 10,000+ miles they run up annually commuting in the vehicle.

2. Similar benefits result when smart homeowners shop online. A click of the mouse uses a lot less gas than a trip to the mall, and the mail carrier and FedEx/UPS trucks delivering the goods will be coming down your street anyway. Americans work more hours than any other society. Both online shopping and teleworking also save a lot of time, a precious commodity for all of us in our society where long working hours leaves too little time for personal relationships and other interests.
3. Because home based business owners and telecommuters are heavy broadband consumers, they provide a revenue base that facilitates broadband expansion to rural areas and underserved markets. The collective additional costs of unfair business activity taxes on Internet commerce would discourage the deployment of broadband access, which is a prerequisite in most circumstances for most teleworkers and home-based businesses.

We urge Congress to protect the Commerce Clause of the Constitution and support the Business Activity Tax Simplification Act, H.R. 5627. The Act establishes a clear definition of physical presence and preempts states from taxing home-based businesses that have no presence in the state. We applaud the Internet Caucus cochairs, Representatives Boucher and Goodlatte, for introducing this important legislation.

We would also like to take this opportunity to suggest related future lines of inquiry for the committee. Because of all the benefits of Internet use it is important that all federal, state and local government policies contribute to the expansion of its use in our society. AHGA believes that the U.S. needs to develop a coordinated set of policies to accelerate the adoption of teleworking and the use of Internet commerce. While the federal government has adopted worthy policies to encourage teleworking (7% of federal workers now telecommute), the few proposals to encourage the same thing in the private sector are receiving scant attention. Even worse, some proposals are discouraging both teleworking and Internet commerce.

For that reason we suggest that the committee hold additional hearings to examine ways that could accelerate the rapid growth in Internet commerce and home-based business creation, especially those with technology based business models. The first step would be to draw attention to other proposals that would have the adverse consequences as a failure to extend the Internet tax moratorium.

Associations representing state government interests have been promoting federal legislation to require Internet sellers to collect and remit sales taxes for state and local governments in every other state. There are thousands of local governments, all with different tax rates and this would be a burdensome on the huge number of small home-based Internet vendors. It would also be an impossible task for the millions more homeowners who hold their yard sales on eBay and craigslist.

In the early days of Internet commerce traditional brick and mortar retailers, who at the time did not have Internet business models, had a legitimate concern about the advantages held by Internet vendors because many of their customers were either unaware of their obligation to pay the sales taxes to their state and local governments, or else chose to ignore that obligation. Today, the cost of creating a basic ecommerce Internet site is miniscule. Internet service companies provide websites along with software to create an ecommerce business for as little as $10 a month. As a result almost all brick and mortar retailers, large and small, have their own robust ecommerce sites, and their ecommerce operations compete on equal terms with Internet-only vendors.

Today almost all businesses, and their customers and the environment, are reaping the benefits of Internet commerce. Even without additional sales tax revenues from Internet sales, tax and other revenues at the state and local level have risen faster than inflation in recent years (thanks in no small part to home appreciation and commensurate growth in real estate tax revenues).

For these reasons AHGA believes its time for state and local governments to stop trying to extract more taxes from Internet commerce. The Streamlined Sales Tax Initiative should be abandoned and they instead should look for new ways to encourage Internet commerce and teleworking.

Many state and local governments offer sales tax holidays for back-to-school expenses. They exempt from taxation some types of purchases, such as prescription drugs, and tax other goods and services at lower rates. Because of the aforementioned benefits an appropriate next step would be for the states to enact a permanent Internet sales tax holiday. Savings on the maintenance and expansion of the state's transportation infrastructure and lower healthcare costs resulting from a cleaner environment would offset the reduction in sales tax revenues. Such legislation would also reflect the sentiments of most constituent homeowners and other consumers, who in public opinion surveys consistently oppose Internet taxes.

States are also discouraging teleworking as a result of the state tax rule known as the "convenience of the employer" rule - a rule that unfairly punishes Americans who work for out-of-state employers and sometimes work from home. This rule is on the books in a number of states. Under New York's convenience of the employer rule, for example, nonresidents who sometimes telecommute to their New York employers may be forced to pay New York taxes on 100% of their income, even though they earn part of that income at home, in a different state. Because the telecommuter's state of residence can also tax the income earned at home, the telecommuter may be taxed twice on that income.

The Telecommuter Tax Fairness Act (H.R. 1360; S. 785) has been introduced to address this problem. It would eliminate the "convenience of the employer" rule, which unfairly punishes Americans who work for out-of-state employers and sometimes work from home. We urge members of this committee to support this

measure, either separately or as a worthy amendment to any energy legislation Congress considers in the future.

The federal government has offered tax credits for the purchase of energy efficient hybrid vehicles, for energy efficient new homes and for spending to make existing homes more energy efficient. Many states offer similar incentives. Congress could further help the environment and accelerate the other benefits of teleworking by enacting legislation to encourage the creation of more Internet-centric home-based businesses and more telecommuting by employees of both small and large businesses. Tax credits provided to employers and workers for such things as broadband expenses and computer/telecom hardware and software would encourage the creation of more home-based businesses and defray the costs of establishing teleworking programs. Incentives and subsidies to expand broadband access to unserved rural and underserved urban communities would also accelerate that process. They would also open up educational and telemedicine opportunities to many of those homeowners and other consumers.

The Alliance appreciates the opportunity to provide these comments in support of H.R. 5627 and to suggest related future avenues of pursuit.

Gerald W. McEntee
William Lucy
Vice Presidents
Ronald C. Alexander
Ken Allen
Henry L. Bayer
George Boncoraglio
Anthony Caso
Greg Devereux
Danny Donohue
David R. Fillman
Michael Fox
Albert Garrett
Ragan George Jr
Alice Goff
Sherry Gordon
Danny J. Homan
Salvatore Luciano
John A. Lyall
Roberta Lynch
Gerard S. Middleton Sr
Michael D. Murphy
Henry Nicholas
Elie Cruz Lopez
Randy Pereira
George E. Popjack
Greg Powell
Eddie Rodriguez
Joseph P. Rugola
Kathy J. Sackman
Eliot Seide
Mary E. Sullivan
David Warnock
Jeanette D. Wise

March 3, 2008

The Honorable Nydia Velazquez
Chair
Committee on Small Business
U.S. House of Representatives
Washington, DC 20515

Dear Madam Chairwoman:

On behalf of the American Federation of State, County, and Municipal Employees (AFSCME) and our District Council 37 members, I am writing to express our concerns about "The Business Activity Tax Simplification Act of 2008 (BATSA)" (H.R. 5267). We are concerned because BATSA would restrict and sometimes even preempt New York State's authority to determine its own internal tax policies and would significantly reduce state revenues, which is extremely problematic given New York State's estimated fiscal year 2009 budget gap of $4.7 billion (8.7 percent) and New York City's similar budget problems.

While we recognize your position on the Small Business Committee and your corresponding advocacy for small business, we urge you to consider BATSA's potential harm to New York's working families and our union members. Without these tax revenues, New York State would be forced to cut back public services or raise other taxes. In fact, as you know, Governor Spitzer opposes BATSA and estimates it would reduce New York's annual tax revenues by $600 million. According to the National Governors' Association, BATSA legislation would result in annual revenue losses of $4.7 billion to $8 billion for all states. Unfortunately, these views were not represented at your February 14 hearing.

We think H.R. 5267, as currently written, is too large in scope and broadbased to address the relatively narrow problems of small businesses. In fact, experts think it would actually confer a relative advantage on large profitable corporations by letting them avoid state taxes if they create sham subsidiaries or use so-called independent contractors to compete with small businesses. After studying the issues raised at your hearing and reading your statements, we think other narrower options are available, which would do far less damage to New York and other states.

We urge you to oppose H.R. 5267 because it restricts states' authority to determine their own appropriate tax systems. It will also significantly reduce New York State's tax revenues. By tightening current federal restrictions on state taxing authority, it increases opportunities for corporations to restructure their operations for the sole purpose of aggressive tax avoidance. This additional corporate tax sheltering will further shift the tax burden onto New York State residents.

We stand ready to work with you on this important issue.

Sincerely,

Charles M. Loveless
Director of Legislation

CML:mgb

cc: Lillian Roberts, Executive Director, District Council 37

Testimony
of
Ivan Petric, Vice-President
Hope Trucking, Inc.
15180 Copeland Way
Spring Hill, FL 34604-8130
Phone: 352-797-4906

IN SUPPORT OF H.R. 5267
On the Nexus Issue of a State's Jurisdiction to Tax
a Business'A ctivity in Interstate Commerce
Before the
United States House of Representatives
Committee on the Judiciary for Small Business
Subcommittee on Commercial and Administrative Law

The Honorable John Conyers, Jr., Chairman

February 12, 2008

Mr. Chairman and members of the subcommittee. Bobby Scott (D-VA), Zoe Lofgren (D-CA), Sheila Jackson Lee (D-TX), Robert Wexler (D-FL), Hank Johnson (D-GA), Artur Davis (D-AL), Stephanie Herseth (D-SD), Elton Gallegly (R-CA), Steve Chabot (R-OH), Mike Pence (R-IN), Tom Feeney (R-FL).

Thank you for the opportunity of allowing me to provide testimony on a matter of great importance, H.R. 5267, the "Business Activity Tax Simplification Act" (BATSA) of 2008 introduced by Reps. Boucher (D-VA) and Goodlatte (R-VA), to the business community in general.

I. Introduction

My name is Ivan Petric, and I am the Vice-President of Hope Trucking, Inc., a small family business, that since FY 2004 has taken very heavy business losses as well as unjust taxation of its business activity in Interstate Commerce when traveling from state to state when it had no physical presence or nexus with states in other jurisdictions. Whereas the taxation system does not reflect the values of ordinary Americans and our long-held belief in the principles of liberty, equality and community. Instead ravenous taxation has given too much credence to purportedly "objective" ideas about taxation that are based on the rationales of law and economics and unverified theories about economic growth and too little credence to human needs for a community that requires allocating the burdens and benefits of the tax system fairly and equitably among the people and entities that make up our societal system. Furthermore, claims from some state government officials of enormous revenue "losses" because of uncollected sales and use taxes on electronic commerce is based on non-validated data collected by a private research firm and is simply not supported by currently available data. Actual data from the U.S. Department of Commerce Census Bureau 2007 E-Commerce Report, analyzed by DMA Senior Economist Dr. Peter Johnson ("Johnson Study"), shows that on-line consumer sales growth has been modest at best.

We are hereby seeking and urging the Congress's support for a bill which will clarify that a reasonable physical presence standard must be applied when determining nexus for Interstate

activity within a state. Our past experience clearly shows what happens when an unclear standard leaves the smallest avenue open to misinterpretation and abuse by greedy States seeking taxable revenues, such as H.R. 3396, that seeks congressional complicity in this effort for the express purpose of expanding the improper jurisdictional reach of state tax systems, which this legislation needs to ensure streamlines and makes more uniform the crazy quilt of existing state and local sales and use tax laws. Congress should not endorse this misnamed exercise in state tax reform in H.R. 3396. Instead, this Subcommittee should urge state governors to work together in a genuine and collaborative effort, under the auspices of the Uniform Law Commission, to standardize the administration of state tax laws.

We are speaking up because thousands of small businesses throughout the United States are totally unaware of these potential risks of abuse in the taxation process. Over the past three years we have had conversations with many people across the Country that have shown to us that such abuses are far more common than is generally recognized or reported.

As you know, without strong Federal legislation, all of these small businesses will soon be unable to participate freely in Interstate Commerce without fear of taxation reprisals, regardless of the rhetoric being expounded by some individuals on behalf of the Streamlined Sales Tax Governing Board claiming that states will experience an ever-accelerating loss in their sales tax bases. You cannot lose that which you do not possess. That tax argument is clearly misleading. Just as we know that people can sometimes be misled by false prophets.

Congress clearly knows that taxation without representation is a basic American principle. It is also very clear that this burden falls the heaviest on small businesses that do not have the resources to contest these ill-founded taxes. The Congress has a constitutional responsibility to ensure that interstate commerce is not harmed by unfair or burdensome taxation. We commend Congressmen Boucher and Goodlatte for introducing this important legislation, and we urge other members to give it their bipartisan support.

Without strong Federal legislation, small businesses will soon be unable to participate freely in Interstate Commerce without fear of taxation reprisals, such as the "centralized, one-stop, multistate registration system that a seller may elect to use to register with the Member States." The small business entrepreneur will be like many other citizens, homeless. We are speaking up because thousands of small businesses are totally unaware of the potential risks of abuse in the taxation process. In fact, it is this inherent tension between the insistence of states on maintaining sovereignty, pitted against the desire to expand their taxing jurisdiction, that makes the state tax reform competitor, H.R. 3396, fatally flawed and doomed to fail in achieving real simplification and uniformity in state and local sales and use tax systems.

II. Background.

Today, states face a new threat to the sales tax revenue they collect. It is they the states themselves. Sadly they have failed to recognize that they have been a key part of the overall problem and refuse to accept the fact that it is their problem to solve without being overly greedy. Many states have been overspending and have placed no self-controls to simplify their aggressive and abusive taxation methods for the 21st Century. The potential abuse of an

open checkbook is dramatically clear that these states will continue to overspend and return nothing back to its customers. If there are any, they are a very few of them.

• ***Why are we testifying***

As a small business we incur substantial costs in order to meet our obligations. This expense results in various costly payments in our efforts to comply with deferral and state laws, especially in dealing with all of the other states, and we continue to find that these state interpretations of the business activity tax to be very difficult and troublesome. I would hope that members of this Committee would question whether forsaking long-standing constitutional standards is the proper response to the greatly exaggerated, and largely self-correcting, problem of lost use tax revenue claimed by state tax officials.

III. The Problem – Bureaucratic Arbitrariness

The U.S. Supreme Court and the Congress have decided that the states may not unduly burden companies that have no physical presence in a state with "business activity taxes."

In 1992, the U.S. Supreme Court held in *Quill Corporation v. North Dakota* that the U.S. Constitution requires a bright line physical presence rule for the imposition of a use tax collection. Many state tax experts and scholars believe that the *Quill* standard applies to all types of state taxes, not just the use tax.

While Public Law 86-272 was enacted by the U.S. Congress to provide a similar bright line standard to bar states from imposing a net income tax on companies whose only in-state activity was the solicitation of sales of tangible personal property, many states, however, are being creative in their new legislation and the courts are rubber-stamping same to bring these added taxable revenues to the state's coffers, by oversimplifying decisions and stating that because we have changed so drastically over the past 40 years the framers original thinking was therefore not in conformity with today's taxation woes.

Of necessity, federalism restricts the ability of a state (or locality) to export its tax system across state borders. Permitting each state to visit its unique tax system on businesses that have no nexus with the taxing state would be chaotic as a matter of both tax administration and compliance (involving fifty state governments, and the more that' 7,500 local taxing districts in the United States, imposing their vastly different tax regimes on businesses in each of the forty— nine other states). Moreover, out—of—state companies would have no way to influence the very state tax systems that are newly imposed on them. In the most real sense, allowing the expansion of tax authority beyond state borders is "taxation without representation."

The Constitutional limitations on the territorial scope of state and local taxing jurisdiction also has enormous economic importance. The United States Constitution — and the Commerce Clause in particular — have been the guardians of this nation's open market economy. The central purpose of the Commerce Clause was to prevent states from suppressing the free flow of interstate commerce by the mere imposition of taxes, duties, tariffs, and other levies as it

clearly becoming. Indeed, more than two centuries 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 has powered the greatest economic engine mankind has ever known.

Despite the U.S. Supreme Court's decision and Congress' efforts to fix this issue, many states continue their uncompromising attempts to tax companies by constantly 'twicking' legislation regardless of the lack of physical presence. States have, for example, enacted and imposed gross receipts taxes, net worth taxes and fixed dollar minimum taxes on out of state companies under the theory that P.L. 86-272 bars only imposition of the net income tax. Many states have argued too, that *Quill* only applies to a use tax. As a result, many businesses are struggling with multi-state tax compliance in the face of very conflicting and confusing guidance. This situation needs to be clarified, and BATSA seeks to do that and not more.

IY. BATSA

Interstate traffic today is more the rule than the exception, not only for large corporations, but small and medium sized enterprises as well. The current state of confusing and arbitrary taxation of small and large multi-state companies that are traversing across state lines only serves to chill interstate commerce. We believe that the BATSA language will help to eliminate the current confusion of going after Interstate Commerce traffic and the need for companies to engage in protracted and costly litigation as one way to improve such tax enforcement discrepancies. BATSA will not diminish the ability of states to collect a legally due tax revenue. Further, it rationalizes and makes more predictable the process of doing so. That pundit's tax arguments are clearly misleading. Just as we know that people can sometimes be misled by false prophets.

V. Recent Taxation Nexus Experiences

In the past several years we experienced several prime examples of this arbitrary and confusing application of several states tax laws in violation of the Interstate Commerce clause. These examples are not a gross exception. In fact, it is just a metaphor of a larger problem.

On June 21, 2005, when our driver was preparing to leave the State of the New Jersey after picking up some empty drum barrels to be delivered to Baltimore, Maryland, to complete the delivery, Hope Trucking, along with numerous other trucking firms, were ambushed on the highway/turnpike as a sting operation by the New Jersey Department of Taxation.

The tax collection agent that stopped one of our trucks, which was loaded with empty drum barrels, on the New Jersey highway/turnpike to be delivered to Baltimore, Maryland, stated that we had not complied with rule ¶ 902 of the Guidebook to New Jersey Taxes, Corporations Subject to Tax, listing "Foreign Corporations" without any further explanation. He further stated that the State of New Jersey had no obligation of providing any notices or legal documentation regarding our non-compliance with New Jersey's law, and that it was our responsibility to know New Jersey's legal requirements when traveling within their state.
The agent held the truck and its driver for several hours, and demanded that, in order to

release the truck, Hope Trucking had to wire $2,200 cash immediately to the New Jersey Department of Taxation. The agent claimed that he had the right to hold the truck and its contents because we had failed to properly file with the state of New Jersey under its governing guidelines as a foreign corporation.

The "Arbitrary Warrant of Execution" listed the assessment under "Corporation Business Tax, N.J.S.A. 54:10A-1, et.seq.", that showed Taxes were seized for Years 2004 and 2005 at $1,000.00 per year, for a total of $2,200.00 with penalty, and that "before our truck could leave New Jersey" we were required to "immediately" pay the "taxes due" on the spot or the truck would be impounded to pay for the taxes due. After reading said document that was faxed to us, we found the language to be vague and meaningless.

I informed the New Jersey agent that his claim was unfounded. I further explained that we had no ties to the state of New Jersey, and that under the law we were protected from New Jersey's taxation since we also had no physical operations in the State. The agent refused to accept this explanation.

The truck and its driver were finally released after we made a $2,200 cash payment and it was verified as received. We subsequently appealed this aggressive, incorrect, and improper application of the law to the New Jersey State tax commissioner. However, this action was totally ignored. We then appealed the improper taxation to the New Jersey Tax Court. Three years later we are still before the Tax Court waiting for a Hearing, and a refund of the improper taxes withheld.

We have also incurred similar unorthodox tactics being applied by Arkansas, Kansas[1], and New York asserting a nexus to the vehicles as property being driven within their jurisdictions.

VI. Conclusion

Our experience is not unique; it is shared by countless businesses, large and small. Many small companies do not have the ability to make an immediate wire transfer of funds much less to obtain an ultimate recourse from these aggressive and abusive states. We believe that BATSA will help clarify the physical presence nexus standard that is embodied in Public Law 86-272 and the *Quill* decision.

Because physical presence has always been intended to be the current standard, BATSA would neither diminish the taxing powers of state and local jurisdictions nor reduce a state's tax revenues. It will allow businesses to concentrate on growing our economy and providing jobs, instead of arguing legal points at great expenses, by ensuring that no undue burdens hinder Interstate Commerce.
Moreover, the non-residents of a particular state are the real victims in Interstate Commerce when they are deprived of the opportunity to exert political pressure upon another state's legislature in order to obtain a change in policy.

[1] K.S.A. 79-6a04 states that a "tax situs" exists for purposes of such valuation, assessment, and taxation, the taxable situs of the over-the-road vehicles and other rolling equipment within the state of Kansas whether owned, used or operated by a motor carrier who is a non-resident of Kansas and irrespective of whether such motor carrier be domiciled in Kansas or otherwise.

Subject: Testimony of Ivan Petric in Support of The Business Activity Tax Simplification Act

It is clearly apparent that the current standards that are being improperly imposed by some states on a simple drive through a state by motor carriers are violative of the Commerce Clause and the Due Process Clause, especially when there is no nexus to that state or any business enterprises therein; but abandoning constitutional ideals in favor of short-sighted efforts by some avaricious states to increase state tax revenues could undermine America's ideals in this crucial, but still fledgling, economy. The vitality to prosper should not be curbed by federal legislation that saddles small businesses with the burdens of disparate state tax laws whose authority wants to be extended far beyond its traditional jurisdictional borders.

With record high energy prices threatening the nation's overall economy, it is certainly now not the time for Congress to abandon the original intent of the Commerce Clause, but to reinforce it from being abused and mis-interpreted. Moreover, a debate over the wisdom of a federal law to expand state and federal tax jurisdiction cannot be divorced from consideration of the overall impact such legislation would have on the competitiveness of American companies. Not only that, but forcing more new tax collection obligations on small businesses would have the undesirable (and undoubtedly unintended) effect of advantaging their foreign competitors, on whom state and local tax collection obligations could never be effectively imposed.

Congress should be skeptical of arguments that the Commerce Clause is outdated and its restriction on state taxing authority is nothing more than a constitutional loophole that is being exploited by businesses.

This does not mean that there are no boundaries to the permissible area of a state's legislative activity. There are. And none is more certain than the prohibition against attempts on the part of any single state to isolate itself from the difficulties that are common to all of them by restraining the transportation of persons and property across its borders to impose its taxes. It is frequently the case that a state might gain a momentary respite from the pressure of events by the simple expediency of shutting its gates to the outside world. But, in the words of Justice Benjamin Cardozo, "The U.S. Constitution [314 U.S. 160, 174] was framed under the dominion of a political philosophy less parochial in range. It was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union and not division."

We urge your support and prompt passage of this bill on behalf of the thousands of small business owners nationwide whose economic futures demand clarity for the continued strength and growth of our National economy.

This is sound public policy and we urge its long overdue passage.

Respectfully yours,
Ivan Petric[2]

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[2] Note: Mr. Petric has a Bachelor of Science Degree in Business Administration, with a minor in Economics. An Honor and Distinguished Military Graduate of the Reserve Officers Training Corps with numerous Distinguished Service Award and Letters of Commendation.

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