

# Interview

## State Taxes

In this interview, BNA talks with Douglas Lindholm, president and executive director of the Council on State Taxation, who recently testified before the Senate Finance Subcommittee on International Trade about a proposed federal nexus standard for state business activity taxes. COST challenges several key assertions of the states—among them, that H.R. 1956, the Business Activity Tax Simplification Act, would cost them billions in lost revenues and that economic presence, rather than the proposed physical presence standard, has been the operative nexus standard in the states for many years.

### COST President Says Industry Believes States Downplay Complexity, Exaggerate Potential Losses From Physical Presence Nexus Standard

**BNA:** According to Montana Director of Revenue Dan Bucks, most states right now have—and have had—an economic presence standard for business activity tax nexus (174 DTR J-1, 9/8/06). If that's the case, then what is driving the demand for a switch to a physical presence standard?

**LINDHOLM:** First of all, I would argue that Mr. Bucks's assertion is a clear case of wishful thinking, although I understand that he has to make that assertion to avoid undercutting state litigation postures. In actuality, however, the vast majority of taxpayers are filing under a physical presence standard. I'd like to quote from Gene Corrigan, the former executive director of the Multi-state Tax Commission, writing in an article in which he was advocating a compromise on this issue: "The states need to face the reality that most of them are generally incapable of enforcing the 'doing business' [i.e., economic presence] standard anyway. In almost all cases they fall back upon the physical presence test as a practical matter. To the extent that they try to go beyond that test to reach out-of-state businesses [for income tax jurisdiction purposes], they spend inordinate amounts of time and effort via bloated legal staffs that provide grounds for criticism of government in general, and with mixed success at best."

**BNA:** So, essentially, when you try to figure out whether a taxpayer is doing business in a state, you're going to end up looking at whether it has a physical presence there.

**LINDHOLM:** Physical presence is a much clearer and more certain standard that both taxpayers and tax administrators can look to for guidance. The U.S. Supreme Court in *Quill v. North Dakota* indicated that physical presence is required for nexus in the sales and use tax arena. The court has not yet offered an opinion on what the standard is for income tax or business ac-

tivity tax nexus; that remains one of the great unanswered questions in the state and local tax field. And in my mind, there is no compelling reason why nexus standards should be different for different taxes.

One could argue, however, that differences in the imposition of a tax could result in different nexus standards. If you accept that premise, it seems the nexus standard for income or other business activity taxes ought to require more of a presence than for sales taxes.

In the sales tax arena, states are only seeking to impose a collection duty (essentially an administrative task); the tax is actually paid by the in-state purchaser. With business activity taxes, states are seeking to impose a direct economic burden (the actual tax) on out-of-state taxpayers—clearly a higher burden. For Mr. Bucks to say that economic presence is the standard is a bit misleading, because if it truly was the accepted standard, we would certainly have a lot less litigation questioning what that standard is.

**BNA:** One of the arguments for the Business Activity Tax Simplification Act legislation is that there is a need to create certainty for taxpayers by enacting a federally mandated standard for nexus.

**LINDHOLM:** Right.

**BNA:** But if it's about uniformity, why is physical presence a better standard? Why not create a uniform definition of economic nexus?

**LINDHOLM:** Part of the problem is the economic presence standard predicates the nexus determination solely on the location of customers in the state, not where the company is actually operating. That's somewhat problematic, because the determination then could hinge on factors outside a company's control.

The other major problem is that companies ought to pay taxes to states where they clearly are receiving benefits and protections from state governments. Since the ultimate beneficiaries of government services—even in our relatively technically advanced world—are still people and their property, a business' physical presence in a jurisdiction (i.e., employees or property) is still the best indication of when a business is part of a taxing jurisdiction's "society" and thus is appropriately subject to its taxing power.

**BNA:** H.R. 1956 sets a threshold for physical presence. If you have activity in a state for 21 days or less, you are deemed not to have physical presence. Why 21 days?

**LINDHOLM:** The 21-day threshold is an effort to set a de minimis standard in order to minimize future litigation on the issue. The Supreme Court in *Quill* indicated the standard was physical presence beyond a de minimis amount but gave no further guidance on the issue. Thus, the majority of the sales tax litigation that has ensued has dealt with how much physical presence is more than de minimis. We're more than willing to work with the states to determine an appropriate level of de minimis presence for the bill.

**BNA:** The bill also provides that the use of an agent to establish and maintain a market in a state will create nexus for an out-of-state company. But if the agent performs services for more than one company—there is no nexus. What is the rationale behind this provision?

**LINDHOLM:** The term "agent" implies someone who is under the control and direction of someone else. If an agency relationship truly exists, then that should create nexus. If the in-state party is working or contracting on behalf of two or more companies, however, that implies there is no true agency relationship, and the mere presence of an independent contractor should not create nexus for the out-of-state company.

**BNA:** There's a fear that this provision will encourage taxpayers to restructure in order to create more independent contractor relationships. But you don't buy that?

**LINDHOLM:** I think that concern is overblown, particularly with respect to its impact on state revenues; it's been a big issue in the Congressional Budget Office and National Governors Association revenue estimates on the bill. Even assuming their assertions are correct, they fail to recognize that those independent contractors operating on behalf of out-of-state companies will see an increase in their respective income and profits, and will thus pay more taxes to the state.

Neither the fiscal notes for the NGA nor the CBO take that offsetting factor into account when they talk about companies that would no longer have nexus in a state under the BATSA legislation. In addition, our legal system is based on the fact that corporations are distinct and distinguishable legal entities, and if states feel that a corporate structure is set up without the requisite business purpose or economic substance, the states have every right to seek to collapse the transaction. And they have an arsenal of common law and statutory weapons at their disposal to do so—including sham and step transaction doctrines, [Internal Revenue Code] Section 482 powers, anti-distortion statutes, and laws requiring the addback of certain payments to related

companies. This legislation doesn't restrict any of those avenues.

**BNA:** Critics of the BAT bill have observed that the push for this physical presence standard for business activity taxes is occurring at a time when many states have drifted away from the traditional three-factor apportionment formula of property, payroll, and sales. According to the Center on Budget and Policy Priorities, these trends are not coincidental. Michael Mazerov of the CBPP has published a paper in which he shows that major corporations have lobbied both for the federal BAT legislation and for the single-sales factor in the states.

**LINDHOLM:** I think that Michael Mazerov went so far as to call it a grand conspiracy, which is laughable.

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**BNA:** How do you counter his charge that these lobbying efforts reflect a concerted attempt by multistate corporations to evade the corporate income tax?

**LINDHOLM:** Mr. Mazerov misses the point that when a state moves to a single-factor apportionment formula, there are typically a larger number of companies hurt by the legislation (i.e., they pay more taxes) than those that benefit.

State legislatures choose to enact single-sales factor apportionment as a benefit for their large in-state employers who have invested heavily in the state. Legislatures make this choice because of the benefits to the state that flow from such an incentive, including job retention and growth (and the resulting increase in state personal income tax revenues) and to encourage additional investment of labor and capital, which increases economic activity generally, thus increasing sales tax, property tax, and other state tax revenues.

State legislatures make this choice at the expense of out-of-state corporations, however, which then pay a higher burden of tax, since by definition they have relatively more sales than property or payroll in the state. These out-of-state companies are not happy with this change, but since they have relatively little presence there, their only option is to seek a similar benefit in those states where they have invested heavily in labor and capital.

With respect to companies lobbying for a federal physical presence nexus standard, they are appropriately responding to the actions of unelected state tax

administrators who are aggressively pursuing their view of an unsettled area of the law. These administrators have every incentive to aggressively pursue out-of-state money because it exports their state's tax burden, but they do not have a similar incentive to assess the impact their aggressiveness has on the free flow of interstate commerce nationally.

**BNA:** So you see no connection between these two trends?

**LINDHOLM:** The fact that they are happening together is very coincidental, because they are driven by different purposes.

**BNA:** As you know, there's a big debate over the impact the BATSA bill would have on state revenues, with the states estimating first-year losses as high as \$3 billion. COST commissioned a study by Ernst & Young that estimated the first-year losses at around \$434 million—but unlike the state's projections, this estimate does not account for the potential impact of tax-related restructurings. Why not address that question?

**LINDHOLM:** With respect to behavioral responses by taxpayers to tax law changes, these are typically evaluated if such responses can be predicted with a reasonable degree of certainty. The states themselves acknowledged this difficulty. The study we commissioned from Ernst & Young cites the California Franchise Tax Board's own analysis of an earlier version of the BATSA bill, where they noted that it was impossible to evaluate the impact of restructuring. Accordingly, given the uncertainty of predicting long-run behavioral responses to H.R. 1956, Ernst & Young did not include net losses related to such activity in the revenue estimates.

**BNA:** Nevertheless—even though the numbers are far apart—every study so far points to some revenue losses by the states. Given that fact, do you see any potential for a compromise? Is it possible to work out a version of the bill that would establish a uniform nexus standard and yet be revenue-neutral?

**LINDHOLM:** I like to think so. A large part of the concern over the revenue figure came from Washington state and Texas—both jurisdictions with business activity taxes currently not subject to Pub. L. No. 86-272 [which prohibits states and their political subdivisions from imposing a net income tax on nonresident taxpayers that operate primarily in interstate commerce and limit their activities in the state to the mere solicitation of orders] and that would be under H.R. 1956. There may be ways to address their concerns about the modernization of Pub. L. No. 86-272 in order to minimize revenue impacts.

**BNA:** What about the factor-presence standard proposed by the Multistate Tax Commission?

**LINDHOLM:** There are many misconceptions about the simplicity and effectiveness of the MTC proposal, apart from the fact that it allows nexus to be predicated solely on the location of a company's customers. It sounds simple to base nexus on a company's apportionment factors, but it's far from simple when you examine the practicalities of how such a system would work. For example, in separate filing states, it asks companies to determine nexus on a unitary basis, which begs the question: "which state's law shall be applied?"

Their response is to suggest the unitary group most commonly filed in other states. But a unitary business determination is very fact-specific, state statutes and case law differ significantly on that question, and many large companies have ongoing disputes with states over the composition of their unitary group. So application of the MTC's separate filing state "solution" is muddy, at best.

The other bedeviling complexity is that the MTC factor-presence standard imposes a brand new sourcing rule for determining which receipts from which companies belong in the formula. So in addition to calculating each state's specific sourcing rule for apportionment purposes, companies would be forced to recalculate the formula under the MTC sourcing rule for every state and for every company in the unitary group for nexus purposes. The task quickly becomes impractical and unworkable, and I fear would result in much litigation.

**BNA:** If you could come up with a compromise proposal, what might such a bill look like?

**LINDHOLM:** I'd hate to speculate. But states are understandably concerned about the revenue loss, particularly those imposing business activity taxes that are not now covered by Pub. L. No. 86-272. If we can address those concerns, the legislation has a reasonable chance.

But I also think that legislators should not be too surprised or concerned that the states would balk at federal nexus legislation that impacts their revenues. That's to be expected.

Congress must recognize that there's a natural and healthy tension between state sovereignty to impose taxes and Congress's responsibility to determine the extent of the burden placed on the free flow of interstate commerce. As I noted earlier, on this issue it appears states are focused on their respective pieces of the revenue pie, and not on the larger national economic picture.

By DOLORES W. GREGORY