

Stop the State Tax Grab

Business levies should be limited to the companies physically present.



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States are hungry for revenue. In hopes of satisfying their appetite, some states are attempting to impose their direct business taxes on nonresident businesses.

This is a source of tremendous legal contention. Under Supreme Court dormant commerce clause precedent, a state may not impose a direct tax unless the business has a “substantial nexus” with the state, but what constitutes a “substantial nexus” is unclear and has provoked a firestorm of fierce debate.

Many state tax experts believe that a business must have employees or property (i.e., a physical presence) in the state for the business to have substantial nexus with the state. Others believe that having customers in a state is sufficient.

State revenue departments have taken a host of inconsistent, and often conflicting, positions. Many states have adopted an unwritten policy of not taxing businesses that do not operate within the state. Others tax businesses that license intellectual property to businesses in the state or that receive a certain amount of revenue from in-state customers.

Even within one state there can be conflicting positions. Some states assert different standards for taxability depending on whether businesses operate as retailers, financial institutions, or licensors of intellectual property. In many states, it is unclear precisely what legal standard the state is using, and the “standard” can even shift from year to year, depending on the state’s fiscal condition and changes in administration.

TREMENDOUS HEAT

One might expect such inconsistent and vague standards to spawn considerable litigation. This is exactly right.

Unfortunately, the litigation has generated tremendous heat but little light. States have won the majority of the litigated cases (but generally only of a particular “tax shelter”

type). Taxpayers, however, have also achieved a significant number of noteworthy victories.

The Supreme Court has refused to put the issue to rest by deciding exactly what it meant by a substantial nexus. In the meantime, unexpected tax assessments mount, and claims challenging those assessments continue to be filed.

The Supreme Court last provided guidance in *Quill Corp. v. North Dakota* (1992), where it held that a state could not force a business to collect a use tax on sales into the state unless the business had a physical presence in the state.

This ruling caused many to reason that physical presence must also be a prerequisite for a direct tax. After all, why would the substantial nexus standard shift depending on the tax type? It would not seem to make sense to have different standards for taxability depending on tax types. State revenue authorities, however, generally interpret the holding in *Quill* to apply only to sales and use taxes, based on an ambiguous sentence in the opinion.

Since *Quill*, electronic commerce has exploded. Many Americans now buy and sell goods through online marketplaces such as Amazon.com and eBay.com. Some states, relying on the argument that the presence of customers in the state is sufficient to give rise to taxability, are arguing that Internet sellers must file tax returns if the sellers have in-state customers.

CALLING CONGRESS

With the Supreme Court apparently unwilling or uninterested in tackling the substantial nexus issue, and the threat of more and more outrageous state tax assertions looming, many businesses are calling for Congress to legislate a clear national standard. These calls are being sounded not only by Internet sellers, but by all types of businesses that operate across state lines.

Legislation has been introduced in the 110th Congress that would create a national physical presence jurisdictional standard for interstate commerce. Under this

Business Activity Tax Simplification Act, states could not impose a business activity tax such as an income tax or a franchise tax on a business unless the business has a physical presence (such as employees, equipment, offices, or real property) in the state.

The BATSA bills (H.R. 5267 and S. 1726) modernize a federal statute, P.L. 86-272, that currently shields businesses from state income taxation if the businesses' only activity in a state is soliciting sales of tangible personal property. The bills extend this protection to solicitation for all types of transactions, including solicitation for sales of services or intangible property.

The bills include all state business activity taxes, rather than solely state income taxes. This change is necessary to close the current loophole that lets states avoid the federal statute by enacting nonincome-based taxes. Many states have enacted nonincome-based taxes such as gross receipts taxes specifically to circumvent P.L. 86-272.

The bills provide a *de minimis* threshold whereby a state cannot impose a business activity tax if the business is physically present in the state for less than 15 days. The bills also protect businesses from taxation if the businesses merely furnish information to customers or affiliates in the state, cover events or gather information in the state, or engage in business activity directly related to the actual purchase of goods or services in the state if the final decision to purchase is made outside the state.

SMALL BUSINESSES

On Feb. 14, the House Small Business Committee heard testimony from small business owners urging passage of the bills. The owners catalogued a number of striking examples of aggressive state taxation against small businesses.

One corporate officer for a chain of sandwich shops described how some states are trying to tax the business simply for entering into franchising agreements with independent businesses in the state. The states are arguing that licensing the business's name and trademarks to franchisees is sufficient to make the franchisor taxable in the state, even though the franchisor is not itself operating in the state. Such businesses are being audited out of the blue and in some cases assessed back taxes *for eight years*, plus penalties and interest.

At the hearing, a small business owner described New Jersey's practice of impounding trucks until the owners submit New Jersey business activity tax returns, payment, and a variety of lengthy and complicated forms. New Jersey is arguing that merely driving a truck on the state highway provides a sufficient basis for taxation.

The small business owners recognized that states need revenue and that state taxation is a business reality. Many of the business owners stated flatly that they have no problem paying taxes in states where they operate and receive significant state benefits.

What the business owners objected to was states that provide insignificant benefits attempting to grab a business's tax dollars. The owners thought that it made no sense for

a state to impose tax simply because a truck drove through the state a single time or because franchisees in a state pay to use a business's trademarks.

Forcing businesses to pay tax where they receive insignificant benefits saps the nation's economic strength and wastes financial and administrative resources, many business owners warned. One owner even testified that he refuses to license his company's software to customers in New Jersey because doing so would create New Jersey tax obligations that would exceed the profits the business receives from New Jersey customers.

STATES WANTING MONEY

Not everyone agrees with the business owners, of course. The states and their supporters strongly oppose BATSA, recoiling at yet another federal statute that would restrict their taxing power.

These groups advance several arguments. The first argument is that the bills would cause the states to lose significant revenue. The second argument is that the bills facilitate illegitimate tax planning. The third argument is that taxation based on "economic presence" is justified because businesses exploit the state market when they sell into the state.

BATSA proponents respond as follows. First, the states generally overstate the amount of revenue that would be lost if BATSA became law. The affected taxes comprise only 0.80 percent of the state business taxes collected in a year. And even if the revenue losses were significant, that argument misses the point. If the states are currently taking significant tax dollars from businesses illegitimately, the states have no solid ground for complaining when they no longer can take those dollars.

Second, the states are wrong when they say that the bills facilitate illegitimate tax planning. A provision in both bills explicitly provides that the bills do not deprive the states of the power to use "addback" statutes and the sham transaction doctrine to curb tax shelters and other illegitimate tax techniques.

Third, BATSA proponents are mystified by the argument that a business is "exploiting the state market" when a business makes a sale into the state. It would not seem that an eBay vendor is exploiting anything when making a sale. The vendor has entered into a mutually beneficial, voluntary transaction with a customer. The vendor is not exploiting the state any more than the customer is exploiting the vendor. To BATSA proponents, engaging in out-of-state commerce is not exploitation, and it should not provide a basis for taxation where a business has no operations in the state.

As of this writing, it is not certain if the BATSA bills will pass this Congress. The bills have an impressive list of cosponsors, but opposition from the states and their agents has already been fierce.

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