Testimony of the National Governors Association

David C. Quam, Director of Federal Relations

Before the House Judiciary Committee

Subcommittee on Commercial and Administrative Law

U.S. House of Representatives

H.R. 5267, the "Business Activity Tax Simplification Act of 2008"

June 24, 2008

Chairwoman Sanchez, Ranking Member Cannon and members of the Subcommittee, I am pleased to be here on behalf of the National Governors Association (NGA) to communicate governors' strong opposition to H.R. 5267, the "Business Activity Tax Simplification Act of 2008."

Governors oppose H.R. 5267:

Governors' long-standing policy regarding federal interference with state business activity taxes is clear and unambiguous. NGA Policy reads:

> **"The nation's governors oppose any further legislative restriction on the ability of states to determine their own policy on business activity or corporate profits taxes. This is an issue of state sovereignty. The U.S. Constitution adequately protects the interests of both states and business." (NGA Policy Position, EC-9)**

H.R. 5267, the "Business Activity Tax Simplification Act of 2008," like its predecessors in other Congresses, represents an unwarranted federal intrusion into state affairs that would allow companies to avoid and evade state business activity taxes (BAT); increase the tax burden on small businesses and individuals; alter established constitutional standards for state taxation; and cost states billions in existing revenue. While governors welcome the opportunity to discuss issues related to business activity taxes, they urge Congress to oppose measures such as H.R. 5267 that would assist large corporations to the detriment of other taxpayers and states.

H.R. 5267 violates core principles of federalism:

Governors oppose H.R. 5267 because it represents an unnecessary intrusion into the states' authority to govern. U.S. courts have long recognized the authority of a state to structure its own tax system as a core element of state sovereignty. H.R. 5267 would interfere with this basic principle by altering the constitutional standard that governs when states may tax companies conducting business within their borders. Specifically, the bill would mandate the use of a physical presence standard for determining whether an entity can be taxed. This differs from economic presence, such as the "doing business" or "earning income" standards used by most states. As discussed below, this

change would shrink state tax bases by relieving out-of-state businesses of BAT liability while allowing larger in-state companies to circumvent tax laws by legalizing questionable tax avoidance schemes. These outcomes would effectively constitute a federal corporate tax cut using state tax dollars – a decision that, fundamentally, should be left to state elected officials.

H.R. 5267 would encourage tax evasion and avoidance:

H.R. 5267 promotes avoidance of state taxation. At a time when the federal government is closing loopholes in the federal tax code, H.R. 5267 would subvert state tax systems by creating opportunities for companies to structure corporate affiliates and transactions to avoid paying state taxes.

The bill's physical presence standard would significantly raise the threshold for business income taxation in most states and, according to a January 20, 2006 report by the Congressional Research Service (CRS) on similar legislation, lead to more "nowhere income." In fact, CRS noted that legislative exceptions to the supposed physical presence standard, including its massive expansion of P.L. 86-272 to services, "would… expand the opportunities for tax planning and thus tax avoidance and possible evasion."

If H.R. 5267 provides the opportunity for planning, corporations will use it to avoid taxation. For example, a recent Wall Street Journal article demonstrated the extent to which corporations already work to avoid state business taxation. ("Inside Wal-Mart's Bid to Slash State Taxes," *Wall Street Journal*, Oct. 23, 2007.) The article details the extensive tax avoidance strategies of Wal-Mart as it sought to reduce its state tax liability through a series of sophisticated strategies, some of which states later identified as abusive and illegal tax shelters. A common thread among the strategies was the formation of entities in jurisdictions that do not tax certain activity, followed by a shift of income to the entity to avoid taxation. If enacted, the physical presence nexus standard of H.R. 5267 would federally codify such tax practices and grant corporations with the

means to restructure their businesses with a federal permission slip to aggressively avoid state taxation.

H.R. 5267 would harm locally-owned and small businesses:

H.R. 5267 would favor large, multi-state corporations to the detriment of small businesses and individual taxpayers. By raising the jurisdictional standard for taxation, H.R. 5267 would effectively limit a state's business activity tax base to in-state companies. Out-of-state vendors could therefore compete for customers against in-state businesses with the advantage of inequitable tax responsibilities.

At the same time, larger in-state companies with the size and means to hire professionals specializing in tax avoidance could minimize or eliminate their state business tax liability even though they are present in the state. This ability to be physically present yet avoid state taxation places a disproportionate tax burden on smaller, in-state businesses and individual taxpayers. Companies willing to compete for customers and earn revenue in a state should share the responsibility of paying for state services that benefit all businesses.

H.R. 5267 would alter established constitutional standards:

H.R. 5267 would alter the existing constitutional standard for taxation of business activity. The U.S. Supreme Court has never required a physical presence standard for imposing business activity taxes. In fact, since the time of this Subcommittee's last hearing on this topic in 2005, state courts, and through its denial of certiorari, the U.S. Supreme Court, have clearly established economic presence, not physical presence, as the appropriate standard for determining if a company has sufficient contacts to impose a business activity tax. (*A&F Trademark, Inc., et al. v. Tolson, 605 S.E. 2d 187 (N.C. Ct. App. 2004), review denied (N.C., 2005), cert denied, 126 S. Ct. 353 (2005); Kmart Properties, Inc. v. Taxation and Revenue Dept., No. 21,140 (N.M. Ct. App. 2001), certx quashed (N.M. 12/29/05); Lanco, Inc. v. Director, Division of Taxation*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (U.S., 6/18/07); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Ct. Civ. App., 12/23/05), *review denied* (Okla.,

3/20/06); *Commissioner 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)). H.R. 5267 would disrupt this well-established constitutional standard and call into question state business activity tax systems in every state.

H.R. 5267 would undermine state revenues:

H.R. 5267 represents a huge unfunded mandate that will result in the loss of billions of state dollars. A survey released by the National Governors Association found that a substantially similar House bill, H.R. 1956, would cost states more than $6.6 billion annually. ("Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, On States," National Governors Association, September 26, 2005.) Preliminary cost estimates for H.R. 5267 yield similar results, with first-year loss estimates ranging from $20 million in a state like Idaho to over $366 million for New Jersey. State losses also will grow as companies restructure to take advantage of H.R. 5267's loopholes. California estimates that if enacted, H.R. 5267 would cost the state $135 million in 2011 then grow to more than $614 million just two years later.

This shift in revenue, while beneficial to business, is particularly harmful to states because unlike the federal government, states are required to balance their budgets. Consequently, when federal action causes states to lose revenues, states must act to replace lost funds by either increasing taxes or cutting programs. The economic effects of such actions are pro-cyclical in that they make economic downturns worse. NGA already predicts that 21 states are likely to face $34 billion in budget shortfalls for fiscal year 2009. Federal legislation that would reduce corporate state taxes by $6 billion annually would only further exacerbate the pro-cyclical pressures on states and thereby prolong the economic downturn and delay recovery.

Conclusion:

States have demonstrated that they are willing to address state tax issues on a national basis. Through projects like the Streamlined Sales and Use Tax Agreement, states

have come together with the business community to fashion workable solutions that address both private and public sector interests.

Unfortunately, in the context of business activity taxes, proponents of bills like H.R. 5267 have shown little willingness to work with states to either properly define the problem or discuss solutions that balance the goals of certainty and consistency with state authority and revenue requirements. As a result, NGA will continue to oppose legislation like H.R. 5267 and call upon Congress to reject legislation that interferes with state business activity tax systems.