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Business Activity Taxes: The New Internet Tax

By Bartlett Cleland

Have you heard the one about the California tax collector pointing heavenward and yelling, “Look, up in the sky! It’s a bird! It’s a plane! It’s…a taxable property!” The joke stems from a report last year that the Los Angeles County Tax Assessor wants to tax orbiting satellites, particularly eight owned by Hughes. According to his theory, the satellites don’t even have to pass over California (in fact, they are fixed over the equator). Moreover, he says that so long as no one else taxes them they are fair game for a state levy.

The California case epitomizes the incredible pro-tax aggressiveness being exhibited by states. Tennessee has wanted to tax J.C. Penney, not because there were department stores within state boundaries (there weren’t) but because a handful of state residents had the retailer’s credit cards. South Carolina sought to tax Toys R Us because the image of the company’s mascot, Geoffrey Giraffe (essentially a trademark and an intangible property) appeared within state lines.

This approach has begun to wear on businesses so much that business activity taxes (BATs) have become a prominent concern not only for traditional companies but also for those within the technology community. BATs are imposed on the corporate income (or as franchise taxes) of businesses that receive presumed governmental benefits and protections from a state. In other words, a business with offices, inventory, employees, or agents within a state pays a BAT.

What Is a Business Activity Tax?

The crux of the BAT is the legal concept known as *nexus,* where a company has enough of a presence in a state that the latter can rightfully levy taxes. Therein lies the problem. The current “substantial nexus” standard for BATs (or, more precisely, the distinct *lack* of a uniform standard nationwide) originates from the Commerce Clause and differs in interpretation from state to state. Unfortunately, this inconsistency often results in double taxation and costly litigation to companies, which ultimately increases the costs of consumer goods. Even worse, smaller companies that cannot afford to litigate end up paying taxes they never owed. Even Steve Rauschenberger, an Illinois state senator and leading supporter of Internet taxation, says, “If you think sales taxes are inconsistent from state to state, business activity taxes are just as inconsistent across the states.”

With clear rules, a company understands when and where it can expect to be taxed. Business planners can then develop and execute interstate business knowing that only its presence and activities within a state will incur a tax liability. This fosters a healthy business environment without artificial market barriers that can retard economic growth. The focus is on success, not litigation.

In the digital world these determinations are particularly critical. As intangible property becomes a greater part of our economy, clear rules that consider the realities of the digital marketplace are a necessity. Viewing an Internet web site, the presence of a computer server, the use of an Internet service provider, the mere presence of customers, or intangible property within a taxing jurisdiction should never provide a sufficient basis for a state or locality to levy a tax on a company not otherwise present within that jurisdiction.

The Current Situation

In *Quill v. North Dakota,* the U.S. Supreme Court required that a company must have more than a minimal (*de minimis*) physical presence in a state before that company can be required to collect that state’s sales or use taxes. The *Quill* standard was crafted because the Court found that collecting sales taxes in multiple jurisdictions in several states was too complicated if the retailer did not have a real presence.

A year ago in March 2002, the economic presence test was reaffirmed when a Tennessee court rejected that state's effort to impose taxes on America Online's Internet services. The court ruled that a state must show that an out-of-state taxpayer has a "literal physical presence." Tennessee wanted to collect taxes because AOL users live within the state even though the company does not maintain a physical presence.

While the Supreme Court has determined that a company must have something greater than a *de minimis* presence in order to be subjected to sales and use taxes, it has not yet ruled on BATs, although several lower courts have extended the *Quill* physical presence requirement to BATs. And to date, the Supreme Court has yet to allow a state BAT when the out-of-state company has no physical presence in that state.

Of course, a common position as to when BATs, sales, and use taxes are collectible makes a great deal of sense. Common standards enhance a company's ability to objectively determine when taxes are to be remitted rather than being victims of a scavenger hunt by tax administrators looking to enlarge their pool of tax revenue. It's also understandable why states oppose any legislation on Capitol Hill that would clarify the situation. A federal law would bring a quick end to states' tax shenanigans.

The Solution

To support the continued development of the borderless marketplace, it is imperative to adopt "bright line standards" that remove the ambiguity around substantial nexus. Because these issues are derived from the Commerce Clause, the U.S. Supreme Court will ultimately rule on what test can be applied to determine the validity of a BAT. The best option would be to apply a "substantial physical presence" standard in which the company is actually present within the taxing jurisdiction—a seemingly common sense approach.

Yet companies, especially in the technology sector, remain concerned about the increasingly novel and aggressive tactics of tax administrators. Even as those same governments court technology businesses to their areas, their bogus claims that taxes should be paid because of "ephemeral interaction" with that state or locality place a huge burden on all businesses, and particularly on the smaller ones. Businesses must be able to figure out when they are required to remit tax and when their activities in no way give rise to a taxable event. This would also eliminate the ability of states and local taxing jurisdictions to bring novel tax theories before the court in an effort to secure a new line of revenue.

Federal Intrusion into State Affairs?

A popular refrain has begun among states in response to federal interest in this issue. States claim that any federal action in this area is unwarranted as an intrusion into federalism principles. Unfortunately, the states are arguing for a sort of federalism that was never intended.

What the states are trying to do is to find an increasing array of means to intrude into other states and tax remote companies and individuals. Federalism never envisioned this sort of approach. Federalism guarantees that the federal government cannot move into those areas where states govern themselves. Moreover, this very issue assumes a transaction that crosses out of a state's boundaries and into another—which becomes an interstate event. Interstate commerce and the activities that impact interstate commerce are the domain of the federal government under the Commerce Clause of the U.S. Constitution.

Conclusion

Defending current understandable business practices and defeating the states' attempts to reach further into corporate coffers costs businesses both time and money. Fighting big government diverts resources and denies consumers the best a company can offer. The lack of a sensible, easy-to-understand physical presence test hinders an otherwise productive and efficient economy, and falls most heavily on the small companies–engines of innovation and employment.

Without congressional action to determine bright line standards, there will be a continued tax assault on interstate commerce, which will create confusion, concern, litigation, and unjust payments. And in an increasingly digital world, those standards should not be subject to the creative whims of an over-zealous tax collector. A company should have at least a physical presence or use some state service before it's required to submit to greater tax complexity. Clearly, even before the end of the last debate on this topic, the new Internet tax is upon us.

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