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Chief Tax Counsel

MARY LOU FAHEY
General Counsel

June 25, 2010

Hon. Stephen I. Cohen
Chairman
Subcommittee on Commercial and Administrative Law
House Judiciary Committee
2141 Rayburn House Office Building
Washington, D.C. 20515

Via email: adam.russell@mail.house.gov

Re: Response to Questions for the Record on the Role of Congress in Developing Apportionment Standards

Dear Chairman Cohen,

Tax Executives Institute, Inc. thanks the Subcommittee for the opportunity to participate in its May 6 hearing and share its perspective on the complexities of our multistate tax system, and apportionment issues in particular. TEI's diverse membership represents a wide range of companies engaging in business across state and national boundaries. As markets expand domestically and internationally, the division of income for tax purposes has become increasingly important — and difficult. Interstate businesses have a critical stake in crafting a tax system that is fair, administrable, and efficient.

TEI's responses to the Subcommittee's follow-up questions are set forth in the attached document. If you or the Subcommittee's staff has any questions about the Institute's views or desire additional information, please do not hesitate to contact Cathleen Stevens, Chair of TEI's State and Local Tax Committee, at 847.735.4672 (cathleen.stevens@brunswick.com), or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

Respectfully submitted,

Tax Executives Institute, Inc.

N. Traubenberg

Neil D. Traubenberg
International President

Questions for the Record
Subcommittee on Commercial and Administrative Law
Hearing on State Taxation: The Role of Congress in Developing Apportionment Standards
May 6, 2010

Tax Executives Institute, Inc.[1]

Questions from the Honorable Steve Cohen, Chairman

1. **In your written statement, you suggest that Congress adopt "a national, uniform threshold for the taxation of nonresident workers." Please explain.**

TEI has supported earlier versions of the Mobile Workforce State Income Tax Fairness and Simplification Act, currently introduced as H.R. 2110. Employers nationwide have a direct stake in the development of fair and uniform rules governing nonresident taxation and withholding, regardless of whether they are large multinational corporations or small businesses that pursue opportunities outside their home state. Establishment of a national standard providing a minimum threshold for taxation of nonresident workers would bring a measure of certainty and uniformity to an area of the tax law where uncertainty and inconsistency cannot help but impede economic growth and efficiency. A national standard would also enhance taxpayer compliance by making it easier for employers to develop standardized systems and processes for tracking and reporting information necessary to accurately withhold state income taxes for traveling employees.

In today's mobile economy, a business' activities or customers are rarely confined to a single state. Regardless of whether a company is large or small, privately held or publicly traded, the pursuit of new business is not limited by geographic boundaries. Employees regularly travel from their usual place of employment (*i.e.*, their "home" or residence state) to other states to fulfill their employment obligations. When they do, they and their employers become subject to a wide array of disparate tax and withholding regimes. The tax and compliance burdens are not limited to any particular class of employee (*e.g.*, those who work for large multinational corporations). Thus, employees of the American Red Cross or another social service/welfare organization whose jobs take them to one or more states devastated by a hurricane to coordinate relief efforts are subject to the same tax consequences as a privately employed individual.

The current patchwork of divergent and sometimes inconsistent regulatory regimes makes it difficult for employers and their employees to comprehend and comply with their obligations. The challenge of analyzing the rules, developing procedures to ensure compliance, training employees, and then undertaking to collect the necessary information and perform the required calculations remains significant. Moreover, while some states may not vigorously enforce their

[1] Tax Executive Institute, Inc. was represented at the Subcommittee's hearing on May 6 by Daniel B. De Jong, Tax Counsel on the Institute's legal staff.

rules in respect of all employers and employees (*e.g.*, where the employer has adopted rules of administrative convenience to withhold tax when employees exceed a certain number of days in the state), the *potential* for enforcement action cannot be ignored.

TEI recognizes the states' prerogative to design taxing systems to meet their particular needs. The Mobile Workforce bill, however, does not strip states of the ability to tailor their tax systems to fit their diverse economies and specific policy goals; rather, it establishes a reasonable threshold regulating when nonresident individuals engaging in interstate commerce and their employers are subject to those tax systems.

2. **In your written statement, you describe the complexities created when business enterprises are composed of multiple entities, and how those entities are considered for tax purposes. You indicate that there is no uniformity among the states. Is there a way to simplify that calculation? Should we look for uniformity?**

Of the 45 states that impose a corporate income tax, 22 require each member within an affiliated group of corporations with nexus to file a separate state tax return – even if the group files a consolidated federal return. Corporations subject to tax in these states account for intercompany transactions with affiliated entities using an arm's-length standard. In the remaining 23 states, affiliated entities conducting a unitary business must file a single combined return. States vary in their definitions of both "affiliated entities" and "unitary business." Generally, entities must be connected by direct or constructive ownership of more than either 50% or 80% to meet the definition of an affiliate. While unitary groups generally exhibit characteristics of interdependence "so as to form one integral business rather than several business entities,"[2] states employ varying factors to determine whether the members of an affiliated group are engaged in a unitary business.[3]

The goal for including these entities in a single combined return is to better capture "the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."[4] The Supreme Court has upheld the constitutionality of mandatory unitary combined reporting in a number of cases.[5] The analysis of whether entities are unitary, however, is often fact-intensive, prone to subjective conclusions, time consuming and administratively difficult. A lack of a consistent definition of a "unitary" business among the states adds to the burdens on taxpayers filing in multiple combined reporting jurisdictions.

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[2] *Pioneer Container Corporation v. Beshears*, 684 P.2d 396, 399 (Kan. 1984).

[3] For example, California applies a definition of unitary that stretches to the limits of the Commerce Clause of the U.S. Constitution. *See* California Franchise Tax Board Notice 89-713 (Oct. 31, 1989). Arizona, on the other hand, has adopted a narrower rule that excludes corporations from a unitary combined return if they provide only "accessory" functions to the overall business of the affiliated group. "Accessory" services in this case are those not contained in the group's products or its delivery to the customer such as centralized management, treasury functions, legal and accounting, and other internal services provided by one branch or affiliate to another. *See R.R. Donnelley & Sons Co. v. Department of Revenue*, Arizona Court of Appeals, Division One, No. 1 CA-TX 08-0007, April 29, 2010.

[4] *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 164-165 (1983).

[5] *See e.g., Container Corp., supra*, and *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298 (1994).

For businesses with international operations, the identification of the entities included in a "unitary group" can be even more daunting. During the 1970s and early 1980s, a number of states required taxpayers with international operations to include those activities in their combined returns (commonly referred to as the "worldwide unitary method") – even where those international operations were conducted through separate, foreign legal entities. The Supreme Court ultimately held that the application of these principles to the international operations of multinational business groups did not violate the U.S. Constitution, without regard to whether those businesses were headquartered outside of the country.[6]

In response to criticism of the worldwide combined reporting, states have migrated to a "water's-edge" approach, offering worldwide combined reporting as an option upon the election of the taxpayer. Under the water's-edge method, unitary businesses generally include only domestic entities in the combined return. More recently, states have begun requiring taxpayers to include an apportioned amount of the income or losses of certain foreign affiliates in an otherwise water's edge return when the foreign affiliates (1) earn income attributable to sources within the United States, (2) earn more than a threshold amount of their income from the sale or license of intangibles or services to other members of the unitary business that are doing business within the United States, or (3) are doing business in a "tax haven" jurisdiction.[7]

States have adopted these rules purportedly to prevent taxpayers from shifting income outside of the water's-edge group to low-tax foreign jurisdictions. Often, however, they ensnare legitimate and common business transactions put in place with no tax avoidance motive. For example, a foreign parent of a subsidiary doing business in the United States may charge the subsidiary an arm's-length rate for the provision of administrative services such as treasury functions, regulatory compliance, tax compliance, or other management-related services. Foreign-owned multinationals also frequently license intellectual property such as patents, trademarks, or copyrights to U.S. subsidiaries for use in manufacturing, printing, or other U.S.-based operations in exchange for a royalty. Under exceptions to the water's-edge rules (summarized above), these foreign parent corporations could be pulled into a state tax return even though they are not required to file a U.S. federal corporate tax return. Including these entities in a water's-edge return imposes an increased state tax burden on multinational enterprises because it often results in state taxation of income that is excluded from the federal income tax base as non-U.S.-source income under the Internal Revenue Code or exempted from U.S. federal taxation under a tax treaty (U.S. tax treaties do not generally apply to state taxes).

Development of a federal solution addressing state combined returns would not be easy; it would almost certainly pit the interests of some taxpayers against those of others. For example, taxpayers with businesses located mainly in states requiring separate company reporting likely would oppose a national standard since it would increase their state tax compliance burden. In contrast, multinational businesses headquartered overseas might agree that a federal rule prohibiting the inclusion of all foreign entities from state combined returns would more accurately reflect their business conducted in the United States. While the conflicts could be tempered by engrafting a series of elections on a national combined reporting framework, such a

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[6] *Barclays Bank PLC v. Franchise Tax Board*, *supra*.

[7] *See e.g.*, MTC Model Combined Reporting Statute §§ 5.A.iv & vi (2006).

labyrinthine system of rules could be viewed as merely substituting one complicated regime with another.

3. **In your opening statement, you stated: "Over the years, there have been repeated efforts to promote state and local tax consistency and uniformity. These efforts have, for the most part, met with limited success for a variety of reasons . . . interstate or international competitive concerns." Please explain in more detail how interstate, and especially, international competitive concerns have impacted those efforts. How has the international community reacted to efforts to promote tax consistency and uniformity in apportionment? Has the European Union dealt with apportionment?**

In 1966, federal legislation was introduced that would have implemented a national two-factor apportionment formula based on a taxpayer's payroll and property. Responding to that federal initiative, many states passed legislation adopting the Uniform Division of Income for Tax Purposes Act (UDITPA), which was promulgated nearly a decade earlier by the National Conference of Commissioners on Uniform State Laws (NCCUSL). That model statute sets forth an equally weighted three-factor apportionment formula based on a taxpayer's property, payroll, and sales. In the years that followed, many states and taxpayers came to regard UDITPA's three-factor apportionment formula as a constitutional standard.[8] That impression changed with the Supreme Court's 1978 decision in *Moorman Manufacturing* upholding the constitutionality of Iowa's single sales factor apportionment formula.[9]

Although states did not immediately discard their three-factor systems, in recent years more and more states have modified their apportionment formulas to provide out-of-state businesses with an incentive to invest there. Thus, today 32 states have moved to apportionment formulas that put additional weight on the sales factor. Illustrating the policy rationale behind this migration, one California legislator recently stated during a hearing on single sales factor legislation that "[t]his bill is about putting California first." While understandable, this trend erodes confidence in the ability of states to achieve conformity or uniformity on apportionment standards on their own.

Although international controversy specific to apportionment has been less common, the related issue of combined reporting has produced significant criticism from foreign jurisdictions and multinational businesses. During the 1970s and 1980s, California and several other states required multinational businesses to include foreign affiliates in their state combined returns (referred to as "worldwide combined reporting"). This effectively pulled the earnings of non-U.S. companies into the state tax net, even though the foreign entities were not even required to file a U.S. federal income tax return. The states argued that their apportionment formulas effectively mitigated the inclusion of those foreign earnings in the tax base and properly reflected the income of the multinational unitary group attributable to the state. Although businesses

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[8] By the 1970s, 44 of the 45 states that had a corporate income tax used a three-factor apportionment formula.

[9] *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

objected, the U.S. Supreme Court upheld the constitutionality of the worldwide combined reporting in two cases.[10]

As a result of the Court's decisions and alarm that additional states might mandate worldwide combined filing, President Ronald Reagan established a "Working Group," whose members represented the affected parties in the dispute: multinational corporations, state governments utilizing the worldwide unitary method, and the federal government. The results for the related hearings were transmitted to President Reagan on July 31, 1984, in the *Chairman's Report On The Worldwide Unitary Taxation Working Group: Activities, Issues and Recommendations*.

Nearly a year after the release of this report, the British House of Commons approved a measure to permit the United Kingdom to retaliate against any states employing the worldwide unitary method by withholding tax refunds on dividends paid by U.K. subsidiaries of U.S. parent companies doing business in worldwide unitary states.[11] Other countries also voiced their discontent with the worldwide unitary system. One representative of Japanese business interests, for example, stated that numerous Japanese manufacturing companies would avoid locating facilities in states that employed the worldwide unitary system and would even consider pulling their existing investments out of those states.[12] In December 1985, legislation was introduced in the Senate and House of Representatives to significantly curtail states' abilities to impose worldwide unitary reporting.[13] Ultimately, as a result of the extreme unpopularity of the worldwide combined reporting concept and the threat of federal intervention, states backed away from requiring its use.

Question 3 also asks about Europe's experience with apportionment. As part of a strategy to reduce tax obstacles that hinder the competitiveness of the internal European market, the European Commission began a project in 2001 to study the efficacy of providing companies that operate in more than one European Union (EU) member state with a common consolidated corporate tax base (CCCTB). One critical issue addressed as part of this project was the allocation of profits among the Member States of the EU, and a related study analyzed three possible mechanisms for apportioning a consolidated tax base.[14] The first option called for a division of profits by the relative gross domestic product (GDP) of the Member States of the EU (or of the Member States in which the taxpayer did business). While simple, the study concluded that this method would not accurately reflect a taxpayer's level of activity in the different Member States since it bases apportionment on something largely independent of taxpayer business activities. The report also considered apportionment based on property, payroll, and

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[10] *See Container Corp. of America v. Franchise Tax Board*, *supra*; *Barclays Bank PLC v. Franchise Tax Board*, *supra*.

[11] For additional information regarding the British response to worldwide combined reporting, *see* Robert D. Wallingford, *British Retaliation Against the California Unitary Tax: The Needed Impetus for a Federal Solutions*, 8 Journal of Comparative Business and Capital Market Law 345 (1986).

[12] Japan, Inc. Reinforces Complaints about the Unitary Method, 22 Tax Notes 653 (1984).

[13] S. 1974 and H.R. 3980.

[14] For additional information on the project evaluating an EU CCCTB, please see the European Commission Taxation and Customs Union webpage on the Common Tax Base, available at http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

sales (similar to systems used in the United States and Canada), as well as a system based on the value added by the taxpayer in each Member State. An in-depth discussion of this study is beyond the scope of these questions, but the conclusion bears repeating: "As expected, the conclusion is that there is no such thing as a 'perfect' mechanism."[15] The EU working group on the CCCTB submitted its final report in 2008, and the issue remains under deliberation.

4. **Your constituency is the business community. As a voice for the business community, please explain why Congress should or should not address the issue of apportionment through legislation.**

Uniformity in state taxation benefits multistate business generally by making the process of computing and paying those taxes more efficient. That lauded efficiency, however, has been subordinated in favor of using apportionment as an economic development tool.[16] Many businesses have responded by locating or expanding operations in those states with more favorable apportionment rules. For example, many manufacturing companies have accepted states' invitations to utilize single sales-factor apportionment rules when deciding where to locate or expand manufacturing facilities. Eliminating the ratios tied to the production of manufacturers' products (*i.e.*, property and payroll) effectively lowers their overall state income tax burdens. For taxpayers located in states with less favorable apportionment formulas, however, the resulting variations in factor weighting or sourcing rules can whipsaw taxpayers, subjecting their income to multiple taxation.

Variations in the rules used to source receipts for purposes of computing the sales factor can also affect the tax liabilities of multistate businesses. Of particular note, states have begun to re-examine the sourcing rules applicable to sales of services and intangibles, with many states sourcing sales based on where the benefits of the services are received by a taxpayer's customers or where the purchaser uses the intangibles. (Absent the change, the sales would have been sourced based on where the costs associated with providing those services were incurred.) The standard of "location of use or benefits derived" is a highly subjective standard which is difficult to administer. The varying rules have produced conditions ripe for double taxation and for taxation on less than all of a taxpayer's income.

While the current patchwork of standards increases the tax compliance burden for multistate businesses, a consensus on whether there should be a national apportionment standard – and what such a standard should be – does not exist. Changes to apportionment formulas by definition redistribute the tax burden among taxpayers by altering the measuring stick used to gauge their economic activity in the states where they do business. A federal apportionment standard would likely eliminate double taxation resulting from the application of inconsistent apportionment rules benefiting taxpayers currently subject to multiple taxation. At the same

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[15] Ana Agundez-Garcia, *Taxation Papers, The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-Jurisdictional Corporate Income Taxation: A Review of Issues and Options*, Working Paper No. 9 (October 2006) at page 86.

[16] *See e.g.*, Sanjay Gupta, Jared Moore, Jeffrey Gramlich, & Mary Ann Hofmann, *Empirical Evidence on the Revenue Effects of State Corporate Income Tax Policies*, 62 National Tax Journal 237, 264 (June 2009) ("States readily admit that the primary reason for apportionment formula changes is to remain competitive and to 'incentivize' businesses to locate/remain in the state.").

time, a uniform federal standard would frustrate the policy decisions made by states to encourage in-state investment. These uneven results make it unlikely that the business community would achieve consensus in supporting any single federal set of standards.

5. **With Michigan, Ohio, and Texas already adopting business receipts-based taxes, and California considering one, do you see more states doing so? What would be the benefits for the business community if states adopted such a tax structure? The detriments? Have businesses seen their tax bills increase dramatically after adoption within these states?**

States income tax collections are inextricably linked to the general economy: If the economy is sluggish and businesses do not generate profits, there is no income for states to tax. This often occurs at the same time demands for state services increase, exacerbating the loss of tax revenue with the increased costs of providing state services. The current economic downturn provides a perfect example of the mismatch. In an effort to reduce this volatility, some states have enacted gross receipts-based taxes on a wide variety of economic activities at a relatively low rate as an alternative to the corporate income tax.[17] Although based on gross receipts, the Michigan tax and California proposals referenced in this question represent taxes better categorized as value-added taxes where deductions from gross receipts are allowed for many business inputs. In May 2010, the Oklahoma legislature passed legislation imposing a new business activity tax based on a taxpayer's "net receipts" – similar to Michigan's new tax.[18]

The gross receipts-based taxes[19] imposed by Michigan, Ohio, and Texas (as well as the proposal in California) share a number of characteristics, but they differ in many important respects. All are imposed at a rate lower than most corporate income taxes, but that lower rate comes at the expense of a much broader tax base. Within each of the taxes, taxpayers must apportion their receipts to the various states using the same or similar sourcing rules as those applying to a corporate income tax. Additionally, each employs a complicated and different method for determining which entities file as part of the group required to complete a return and pay tax. As a result, while perhaps stabilizing receipts, these new taxes did *not* simplify state tax compliance for multistate businesses. Indeed, they created greater uncertainty by replacing a corporate income tax that had developed over many years with untested taxes that both taxpayers and tax administrators struggle to apply without the benefit of experience.

The effects of these new taxes on multistate businesses have varied significantly. Because the tax is based on gross receipts and not net income, businesses generate tax liabilities even in years when they would have no positive taxable income under a traditional income tax. This significantly increases the tax burden on companies struggling financially that already must pay other taxes not based on net income such as local property taxes and sales and use taxes. Thus,

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[17] *See, e.g.*, Report of the California Commission on the 21st Century Economy (September 2009) at 44, *et seq*. Texas does not fit this same mold. Its move to a receipts-based tax was prompted more by a prohibition within the state constitution against the imposition of an income tax on individuals.

[18] S.J.R. 61.

[19] For ease of reference, both pure gross receipts taxes (*e.g.*, Ohio's Commercial Activities Tax) and value added taxes (*e.g.*, Michigan's tax) are referred to as gross receipts taxes.

gross receipts-based taxes are disadvantageous for businesses with current operating losses. For those businesses consisting of an affiliated group of entities, the effects of gross receipts-based taxes that require combined reporting vary according to whether new entities brought into the combined tax return reduce the group's apportionment to these gross receipts states enough to mitigate the more expansive tax base. Given the myriad ways in which these taxes affect multistate business, it is difficult to provide any generalized conclusions about their effects.

6. Of the several formulas states currently use, rank the formulas in how they benefit businesses. Or are the benefits different based on the type of industry or whether a business is multi-state?

The varying apportionment rules used by states affect business differently depending on factors ranging from geographic location and type of business to legal structure and other attributes, so it is impossible to rank them. Manufacturers may benefit from an apportionment formula consisting of a single sales factor that sources sales to the state in which customers receive their goods, at least to the extent that the business ships most of its products to purchasers located outside the state in which its manufacturing facilities are located. Any benefits created by that single sales factor apportionment formula might be eliminated, however, if the state enacted a throwback rule requiring all sales to states in which the manufacturer does not have nexus to be included (or thrown back) into the sales factor numerator of the state from which the products were shipped. That same manufacturing company would prefer that the states in which it did not have manufacturing facilities employ a three-factor apportionment formula since its apportionment ratio in those states would be lowered by the lack of property or payroll in those jurisdictions. These rules, however, disadvantage manufacturers located in states with less favorable apportionment rules. This pits the interests of some manufacturers against those of others.

Similar considerations exist for service providers and businesses dealing in intangibles. TEI's written statement provides an example showing how a taxpayer could reduce its state tax burden by two-thirds simply by moving its location from one state to another. That benefit would evanesce, however, if either of the states in that example changed their approach to sourcing sales of services for purposes of the sales factor. This could put the interests of service businesses located in one state at loggerheads with those based in other states.

States have also constructed special apportionment formulas and sourcing rules for specialized industries in an attempt to better reflect the location of their business activities. For example, oil pipeline companies and transportation companies often use a formula based on property in the state or on miles driven in the state to apportion their income. A uniform national apportionment standard that did not take into account these factors could significantly alter the tax liabilities of those businesses.

7. **In your opinion, looking at this from a policy perspective, not a states' rights perspective, what should Congress do regarding state tax nexus rules? What is the fairest rule? The simplest rule?**

The lack of clarity and uniformity in the states' definitions of business activity tax nexus imposes significant burdens on business taxpayers. The range of possible rules is so broad – and their effect on particular industries or taxpayers so divergent – that it is impossible to define, as a general matter, what the fairest, simplest, or best rule is. There is a growing consensus, however, that a national standard for determining the jurisdictional limitations on states' rights to tax multistate businesses is necessary for U.S. and non-U.S. businesses alike.[20] Thus, TEI commends the Subcommittee for holding its recent hearing to examine the issue more closely.

A single "bright-line" test for nexus would govern only the taxing jurisdiction of the states, and would not interfere with the use of state tax codes to encourage in-state investment through the use of apportionment formulas, targeted credits and grants, or special additions or subtractions from the tax base. Those types of policy decisions would remain in the hands of the states avoiding any undue erosion of the principles of federalism, though concededly the contours of any such decisions might be affected by a national nexus standard.

8. **Imagine that Congress addresses the state tax apportionment issue which we are discussing today, and establishes a uniform standard. How would this affect the business community's revenues? Would it make a difference where the businesses were located, such as in-state or out-of-state? Do you have accurate numbers on the effect of establishing such a standard?**

The possible effects of a national set of apportionment rules would vary depending on numerous factors described in detail above (*e.g.*, geographic location, industry, choice of legal entity, *etc.*). No draft legislation currently exists, however, that would permit quantification of the effects of a uniform standard on the business community.

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[20] U.S. tax treaties do not apply to most state business activity taxes, and the amount of contact necessary to create nexus in a state for a foreign business may be significantly less than that required to create a federal tax filing obligation. Consequently, foreign businesses may find themselves subject to a state business activity tax while exempt from the U.S. federal corporate income tax. *See e.g.*, *Matter of Infosys Technologies Limited*, DTA No. 820669, N.Y. Div. of Tax App. (Feb. 21, 2008), *aff'g* DTA No. 820669, N.Y. Div. of Tax App, ADL Unit (Feb. 15, 2007) and Washington State Department of Revenue, Special Notice: New "Economic Nexus" in Washington State May Impact "Foreign Corporations" (May 28, 2010).