Statement of Pete Vegas
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Before the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Hearing on H.R. 2992, the "Business Activity Tax Simplification Act of 2013"

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Members of the Subcommittee; my name is Pete Vegas and I thank you for allowing me to speak before you today. I am the founder and owner of Sage V Foods. Sage V Foods is primarily a manufacturer of rice based food ingredients. Our sales are about $100,000,000 per year. I provide good jobs and health insurance to over 200 people and have invested over $65,000,000 in new plant and equipment in the last seven years. Our customers are primarily large food companies. We do not sell any products directly to consumers. We are a LLC, so for tax purposes our profits flow through to me personally. In addition to federal Taxes, I pay state taxes in the State of California where I currently reside, as well as taxes in Arkansas, Texas, and Louisiana. I have no issue with paying tax to any of those states as I have assets and employees in those states that generate income for my company or me personally and my company uses the services of those states.

I recently had a very nasty and grossly unfair encounter with the Revenue Department of the State of Washington. This situation forced me to learn what a serious problem our country is facing in regards to unfair taxation of interstate commerce by many states. Specifically, some states are now unfairly collecting the tax revenue they need from companies located entirely outside of their state; companies that do not use services of the state. Very few small companies have yet to learn of this problem, but they soon will as the problem is quickly spreading. Federal statutes do not prevent the states from generating all of their tax revenue from residents and companies located outside of the state (though I think the U.S. Constitution does). Imagine how popular you would be as a politician if you could raise revenue to provide protections and benefits to your constituents without requiring your constituents pay additional taxes. Taxing non voters from outside your state is a much simpler solution to state budget problems than raising taxes paid by voters or cutting costs. More and more states are taking advantage of this opportunity. (Attached is a recent article that describes problems that other companies have faced.)

In my particular "run in" with the State of Washington, Sage V Foods was selling rice flour delivered in bulk railcars to a Con Agra owned facility in Pasco, Washington. The Con Agra facility blended rice flour with other ingredients to make a coating blend that was packaged and shipped to its Lamb Weston facilities and subsequently used to coat fried French fry potatoes to be shipped to a major hamburger chain. We had other small customers in the State of Washington, but over 90% of our business was the sale of bulk rice flour to Con Agra in Pasco, Washington. I estimate that less than 6% of my product utilized by Con Agra was actually sold to consumers in the State of Washington.

In 2010 one of our trucks carrying rice flour to a small customer in Washington was stopped at a weigh station and our name was collected by the Washington Department of Revenue. A few months later my controller received and answered a questionnaire from the State. We answered "no" to all questions, including "has your company warranted its products or services," "has your company maintained an office or other facility in Washington", "have you leased equipment for your own use in Washington", etc. But in response to the question "how many visits per year", my controller knew that 0 was not accurate, so she answered 1. In later phone calls with the Washington Revenue Department, we explained that we had visited only once in the 7 year period being audited. That clarification had no impact and we were issued a bill for $180,266.95 for back taxes, penalties, and interest; and then forced to continue paying taxes at the rate of about $20,000 per year. We paid $217,434.76 before I stopped paying. It is important to note that the State of Washington did not charge me income taxes; they charged Washington's substitute for an income tax, its Business and Occupation Tax, which is a tax based on my company's gross sales into the state. It is also important to note that unlike the income taxes that I pay in Arkansas, the Washington tax is not a direct offset to my California taxes, and it is payable whether my company earns a profit or not.

From a practical standpoint, there is no way for a company of our size to understand every oddball tax law in the 50 states of this country. I did not know at the time whether this practice of taxing entities that conduct all their activities outside of the taxing state was legal. Every business man that heard of my case was shocked that the State of Washington could charge my company taxes simply because I visited a customer in the State.

First Appeal.

I hired an attorney and appealed my case. My first appeal in September of 2011 was before a Judge employed by the Department of Revenue. It was immediately clear that our arguments were falling on deaf ears. Judge Okimoto explained that there was plenty of legal precedence in Washington to establish that merely visiting a customer in the state was enough to establish nexus. He said there was no bright line that established how many visits within a certain period of time established nexus. When I asked him what he thought, he answered with certainty that in his opinion one visit to the state (not one visit per year) was enough to establish nexus. We lost the appeal, and were forced to make immediate payment of the tax and penalties assessed.

Second Appeal.

I spoke with several attorneys in the State. They all agreed that my situation was grossly unfair, but they all stated that the Washington Dept. of Revenue was known to be grossly unfair and that I was certain to lose. They warned me that the Dept. of Revenue would fight to the bitter end and my costs of defense would far exceed my winnings. They stated that it would be a waste of money to hire an attorney and continue the fight. Because I am bull headed and often choose principal above money, I chose to defend myself and appeal my case before the Board of Tax Appeals and a panel of three judges. I studied the Constitution, Supreme Court rulings, and most of the precedent setting cases in other states and in the State of Washington. The "golden rule" in this area of law seems to be the Supreme Court case of "Complete Auto Transit v Brady in 1977". This case established a four prong test for constitutionality of a tax under the Commerce Clause. For a tax on an out of state company to be legal, all four prongs of the test must be satisfied. I argued that Sage did not meet the following 3 prongs of the four part test.

Substantial Nexus. An activity with substantial nexus in the Taxing State. I explained that I had only visited my customer one time in the 7 year period and that I made no effort to sell my products in the meeting. I explained that my sale had been made to the burger chain that used the French Fries (headquartered in another state) and my company was the named supplier in the spec sheet. Con Agra was essentially required to buy my product and so I did not need to sell them during my visit.

Fair relationship. Is fairly related to services provided by the State. I presented Washington's spending budget (Human Services, Public Schools, Higher Education, Transportation, Govt. Operations, Natural Resouces, Debt Service, etc) and I explained that Sage used absolutely no funds from the State of Washington. Our product was delivered via a railroad track owned by the Union Pacific Company and Con Agra. We did not even use Washington highways.

Fair Apportionment. Is fairly apportioned. I presented a chart that showed the percent of my company's assets, employees, and sales in the various states where I pay taxes (California, Arkansas, Texas, and now Washington). I then compared that to the percent of taxes charged by each state and demonstrated very clearly that the amount of taxes paid to the state of Washington was way out of line. I also demonstrated that the Business and Occupation tax charged by the State of Washington amounted to a 16% income tax and was higher than any income tax charged by any other State in the US.

I won a unanimous decision before the Board of Tax Appeals. They agreed that my one visit to Con Agra, which did not impact my sales to Con Agra, was not enough to establish Nexus. They did not rule on my arguments about Fair Relationship and Fair Apportionment. It should be noted that Complete Auto Transit and related rulings by the Supreme Court have been largely ignored by state courts, and have not been very successful in preventing flimsy nexus determinations in many years, maybe ever.

Third Appeal.

The Dept. of Revenue appealed to the Superior Court of Washington for Thurston County. Once again, I spoke with several attorneys in the State. They were very impressed and surprised that I won my appeal, but all advised me that the Dept. of Revenue would continue to appeal until a court turned down their case. My attorneys' fees would far exceed my recovery of funds. I tried to defend myself, but the Judge ruled that it was not legal to represent myself at this level in the Washington Court system. I found an attorney that was very interested in my case and offered to defend me at a reduced rate.

The Dept. of Revenue continued to argue that my one visit to the state constituted nexus, but this time they tried a new tack and focused on the fact that I used leased rail cars to deliver my flour to Washington and therefore claimed that I had leased assets in the State.

Our attorney argued that the State of Washington's own law is that to establish nexus "the activities in the state must be significantly associated with a person's ability to establish or maintain a market for its product in the state". Our product could have been delivered in many ways (Con Agra-owned rail cars, Union Pacific-owned rail cars, or trucks.). Our leased cars were not associated with our ability to establish or maintain a market and neither was my one visit to the state.

The judge ruled in our favor. After this ruling, instead of facing another appeal, Sage settled the case and recovered much of our taxes and penalties paid. Our funds were finally returned in Aug of 2013, three years after this ordeal started.

We won in principal, but it is very doubtful that the winnings covered the time and money we put into the case.

Conclusion.

The "Commerce Clause" of the US Constitution is found in Article 1, Section 8, Clause 3, and simply states "that Congress shall have the power to regulate commerce with foreign nations, and among the several states, and with the Indian Tribes".

Congress has not done a comprehensive enough job to regulate commerce among the several states and so this job has been taken up by state and local revenue departments and state courts. The Supreme Court has not addressed the issue of business activity tax nexus since it touched on the matter in the Quill case in 1992. It is unlikely that it will again, since the Constitution clearly makes it the responsibility of Congress. So recent rulings have come from lower state courts in those jurisdictions that are looking to take advantage of the situation. The last time the Supreme Court visited this issue, in the Quill case, they required a physical presence to establish nexus to impose a tax obligation on a nonresident company. The basis of this ruling has essentially been ignored by several state courts, as has the four prong test set forth in the Supreme Court case of "Complete Auto Transit v Brady in 1977".

So we now have a situation where the State of Washington expects Sage V Foods to pay Washington taxes simply because we have customers in the state. But it does not expect Washington based

manufacturing companies that ship their products out of state to pay the same type of Washington taxes, despite the fact that those companies have substantial assets and employees in the state and use the services of the state. The State of Washington does not charge its residents any income taxes. The State of Washington does not charge its residents income taxes to send their kids to public schools and because of that they expect Pete Vegas, a resident of California, to pay for Washington public schools.

This situation is getting out of Control. Congress needs to set things right.