[ERRATA]

BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2011

HEARING

BEFORE THE

SUBCOMMITTEE ON COURTS, COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

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[ERRATA]

This document includes material which was submitted for the record of this hearing, within 5 legislative days thereof, but was inadvertently omitted from the original printed version of the hearing.

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Material Submitted for the Hearing Record

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Updated April 27, 2011

PROPONENTS' CASE FOR A FEDERALLY-IMPOSED BUSINESS ACTIVITY TAX NEXUS THRESHOLD HAS LITTLE MERIT

By Michael Mazerov

A bill under consideration in the U.S. House of Representatives would strip states of their current authority to tax a fair share of the profits of many corporations that are based out-of-state but do business within their borders. The Subcommittee on Courts, Commercial and Administrative Law of the House Judiciary Committee held a hearing on the "Business Activity Tax Simplification Act," ("BATSA", H.R. 1439) on April 13. At present, there is no Senate version of the bill.

BATSA would impose what is usually referred to as a federally-mandated "nexus" threshold for state (and local) "business activity taxes" (BATs). State taxes on corporate profits are the most widely-levied state business activity taxes. The term also encompasses such broad-based business taxes as the New Hampshire Business Enterprise Tax (a form of value-added tax), the Texas Franchise Tax (a tax on businesses' "gross margins"), and the Washington Business and Occupation Tax and the Ohio Commercial Activities Tax (both are taxes on businesses' gross sales). The "nexus" threshold is the minimum amount of activity a business must conduct in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State business tax laws will set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must file a tax return and pay any tax that is owed. Federal statutes can override state nexus laws, however, and BATSA proposes to do just that. BATSA would create a number of new nexus "safe harbors" — categories and quantities of activities conducted by corporations in states that would be deemed no longer sufficient to establish BAT nexus for the corporation.

A previously-published Center on Budget and Policy Priorities report provides an overview and analysis of the proposed legislation. (See: "Proposed 'Business Activity Tax Nexus' Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy," updated April 13, 2011, www.cbpp.org/6-24-08sfp.pdf. Hereafter referred to as the "Center's analysis of BATSA.") That report focused on the adverse impact of BATSA on the revenue-raising capacity and fairness of state corporate income taxes.

This report has a different objective: to rebut the key claims made by the proponents of BATSA as to why its enactment is necessary. (Readers unfamiliar with the business activity tax nexus issue may find this report more useful if they have already read the previous Center analysis of BATSA.) This report will demonstrate that the sometimes reasonable-sounding arguments offered in support of the legislation actually have little merit and are mainly a smokescreen to obscure the corporations' straightforward goal of cutting their state tax payments.

The following are the key arguments offered in support of the enactment of BATSA, paired with rebuttals.

Claims About Why the Bill Is Needed In General

Claim:

BATSA establishes a "physical presence" nexus threshold for state BATs. Such a threshold is fair because businesses don't benefit from public services to any meaningful extent in states in which they don't have employees or facilities and therefore shouldn't be obligated to pay any BAT to such a state.

Rebuttal:

- BATSA does *not* establish a "physical presence" nexus threshold. A true "physical presence" nexus standard would provide that a corporation that has employees or property in a state is taxable there and a corporation that is not physically present is not taxable. In actuality, BATSA would allow corporations to have *unlimited* amounts of several categories of employees, agents, and property in a state without establishing nexus for business activity taxes. For example, the bill would allow a corporation to have an unlimited number of salespeople in a state using company-owned computers and driving company-owned cars without creating BAT nexus, as long as the salespeople worked out of their homes or visited from out-of-state.

- Such employees and property are clearly benefiting from state-provided services like roads and police protection, negating the fundamental rationale offered for BATSA.

- Out-of-state businesses often benefit substantially from public services provided by states in which they have no physical presence but do have customers, and can reasonably be expected to pay some amount of business activity tax to such a state. For example, when an out-of-state bank makes mortgage loans in a state, the value of the houses that serve as collateral on the loans depends critically on the quality of local schools where the home is located, and the collateral itself is protected by local police and fire services. Moreover, banks use the local court system to foreclose on the loans if borrowers don't repay. The provision of such services justifies the payment of some income tax by the bank to the states where its borrowers are located, notwithstanding its lack of a physical presence in such states.

- In most states the *amount* of income tax a corporation owes substantially depends on the amount of physical presence the corporation has in the state; the more employees and property, the higher the tax payment. That is appropriate under the "benefits received" principle of taxation, because businesses are likely to benefit more from public services the more workers and property they have in a state. But to suggest that a non-physically-present business should have *no* tax obligation to the state is unreasonable given the fact that it is earning income in the state and benefiting from services provided by the state.[1]

- In its 1992 *Quill* decision, the U.S. Supreme Court said explicitly that a non-physically-present mail-order company that purposefully availed itself of a consumer market in North Dakota *was* benefiting sufficiently from public services provided by that state to be fairly required to collect and remit sales taxes to that state. The fact that the decision nonetheless upheld a "physical presence" nexus threshold for sales taxes was based on the court's desire to protect interstate commerce generally from excessive sales tax *compliance* burdens, not on the grounds of unfairness to the Quill Corporation itself.

Claim:

BATSA is needed to "codify" federal and state court decisions that strongly imply that "physical presence" is the nexus threshold for BATs under the U.S. Constitution, because a small number of recalcitrant, aggressive states refuse to accept the clear message being sent by the courts.

Rebuttal:

- Two U.S. Supreme Court cases, *Whitney* v. *Graves* (1937) and *International Harvester* (1944) make clear that a person or business that receives income that has a source in a particular state need not be physically present in that state for the state to tax the income. Perhaps with these cases in mind, the U.S. Supreme Court stated in its 1992 *Quill* decision: "[W]e have not, in our review of other types of taxes, articulated the same physical-presence [nexus] requirement . . . established for sales and use taxes."[2]

- State courts are split on whether a state can impose a BAT on a non-physically-present business, but at this point in time 11 state courts have held that they can and only two have held that they can't.[3] Moreover, the six most recent cases have sided with the states' position that physical presence is *not* required for BAT nexus.[4]

Claim:

BATSA is needed to reverse those state court decisions that have held that physical presence is not required for BAT nexus, because they likely were wrongly decided. In the 1992 *Quill* decision, the U.S. Supreme Court held that an out-of-state business must be physically present in a state before it can be required to collect and remit sales tax to that state. Logic demands that the nexus threshold for BATs be *at least* "physical presence," because a BAT is imposed directly on the business and comes out of the business' pocket, while a sales tax is merely collected from the customer by the business.

Rebuttal:

- As explained above, the "physical presence" nexus threshold established in *Quill* was based on the Court's desire to protect interstate commerce from excessive sales tax *compliance* burdens, not on any concerns about the *economic* burden on the company itself. Sales taxes have a much greater potential to interfere with a business' engaging in interstate commerce than corporate income taxes and other BATs do, because a company that is obligated to collect sales taxes from customers on behalf of a state must engage in numerous activities before it makes a single sale. For example, it must register as a sales tax collector, it must identify every one of its products and its customers as taxable or tax-exempt, it must program its accounting system to charge its taxable customers the proper tax, and it must actually collect the tax from them and maintain records to demonstrate to an auditor that it has done so. In contrast, the only thing a company must do to comply with a BAT is properly fill out its tax return based on its general books and records. Given the greater burdens of sales tax compliance as compared to BAT compliance, one could reasonably argue that it is appropriate to have a *higher* nexus threshold for a sales tax than for an income tax or other BAT.

- It could also be argued that the sales tax nexus threshold should be higher than the BAT threshold because in the case of the sales tax a business is being "drafted" to collect a tax that is actually owed by the purchaser and that the state would be capable of collecting directly from the purchaser (with sufficiently intrusive auditing). In contrast, a BAT is the legal liability of the business being asked to pay it; there is no other party from whom the tax could be collected. (One could not reasonably ask the in-state purchaser to estimate the *profit* earned on her purchase and send the tax due on it to the home-state tax agency rather than to the seller.) Thus, if states are to have the right to tax income earned within their borders by individuals and businesses alike (and no one proposes that they be stripped of this long-established right), and if businesses are capable of earning such income without being physically present (which they are), it is illogical for states to be barred from taxing that income merely because the business is not physically present within the state.

Claim:

The principles of federalism embodied in the U.S. Constitution, which vests in Congress the authority to regulate interstate commerce, demand that Congress enact legislation to establish a uniform national BAT nexus standard.

Rebuttal:

- No one questions the authority of Congress to enact BATSA; the debate is over the wisdom of its doing so.

- "Federalism" is not merely about the mechanical division of authority between the federal government and the states. Its principles also encompass notions of deference and comity toward states on the part of the federal government. State and local governments are partners with the federal government in providing essential government services like education, health care, and transportation, which they cannot provide if their powers of taxation are unduly and unnecessarily interfered with. Congress has enacted several laws limiting state taxing powers that have spawned substantial, costly litigation and led to adverse, unanticipated consequences for states because Congress did not take adequate care in drafting them. BATSA has the potential for many such problems. Congress should therefore give great deference to state tax policies absent a compelling showing that they are contrary to the national interest.

- Federalism is often justified as a means of keeping government "close to the people" so that elected officials can be held accountable to citizens. Federal preemption of state taxing powers violates this goal, because it enables Congress to provide tax cuts to business interests at state expense with no accountability for any adverse consequences that result. It will be state officials, not members of Congress, who will be blamed if public services are reduced or household taxes are increased to compensate for tax cuts that have been provided to businesses by BATSA. Thus, the enactment of BATSA would undermine a key objective of federalism.

Claim:

BATSA is needed to stop states from asserting that they have the right to tax corporations that do no production within their borders but merely have customers there. Such a position is illegitimate because corporations earn income only where they produce goods and services, not where they sell them.

Rebuttal:

- The corporate income tax laws of virtually all states incorporate provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was promulgated in 1957 as a model state law for dividing corporate profits among the states for tax purposes. UDITPA was developed in a joint business-state task force, and it explicitly recognized making sales as an activity that contributes to the generation of business profit. Thus, in making the above claim, BATSA proponents are seeking to deny the existence of and reverse a 50-year-old consensus between the business community and state tax officials concerning where profits are earned.

- Much more recently, in the early 1990s, the Multistate Tax Commission (a joint agency of state tax departments), developed model rules aimed at clarifying where profits from such services as banking, publishing, and radio and TV broadcasting should be deemed to be earned. The traditional rules had assigned such income to the states in which the production of those services occurred. The new rules developed by the MTC assign that income, to a much greater extent, to the states in which the customers of those businesses are located. Several corporations playing a prominent role in lobbying for BATSA *supported* the adoption of the new MTC rules covering their industries.[5] Thus, the claim that "corporations only earn income where they produce, not where they sell" is completely inconsistent with the explicit position taken by many of the bill's proponents as recently as 15-20 years ago.

- Many corporations supporting BATSA have actively worked to enact legislation at the state level that is based on the premise that corporations earn profits *only* in the states in which they sell, and *not at all* in the states in which they produce (see: www.cbpp.org/1-26-05sfp.htm).

Claim:

Under international tax treaties that apply to *national* corporate income taxes, the nexus threshold for multinational corporations being taxable in another *country* is a "permanent establishment" (PE), that is, a brick-and-mortar facility. This is a further demonstration that the "physical presence" standard that BATSA would implement is an international norm for corporate income tax nexus.

Rebuttal:

- The PE threshold is part of a U.S. international tax structure that is completely different from the structure of state corporate income taxes and therefore is irrelevant to the nexus rules that should apply to multistate corporations. For example, since U.S.-based corporations are subject to tax on their worldwide incomes, PE rules affect only *where* a U.S. corporation's profits are taxed, not *if* they are taxed. In contrast, if a federal nexus law blocks a state in which a corporation has customers but no direct physical presence from taxing that corporation, a significant share of that corporation's profit is likely to be completely untaxed by any state. (See: www.cbpp.org/12-13-05tax.htm.)

- There are a significant number of policymakers who question the continued appropriateness of the PE standard for national-level corporate income taxes.[6] For example, a recent report of an Organization for Economic Cooperation and Development task force noted: "An enterprise now has the ability to electronically project a business presence to almost any corner of the globe and to deliver many products and services electronically. Enterprises no longer need to establish branch offices, staffed with people who can provide local services or face-to-face contact, in each of its major markets. The need for a human presence (and supporting physical infrastructure) in diverse locations may be much reduced. *In these circumstances, these [task force] members questioned whether a taxing threshold built on physical presence of an enterprise remains appropriate.*" [Emphasis added.] The fact that the task force recommended no change in the PE rules was attributable to its inability to agree on an alternative likely to be widely adopted, not on a consensus that the PE rules themselves remain correct.[7]

Claims About the Need for Specific Provisions of the Bill

Claim:

BATSA contains reasonable "safe harbors" that allow a corporation to have a "de minimis" amount of physical presence in a state before establishing nexus. The provision of BATSA that allows a corporation to have employees or property in the state for up to 14 days in a tax year without creating nexus is such a reasonable "de minimis" threshold.

Rebuttal:

- The 14-day safe harbor is completely inconsistent with the underlying rationale for BATSA, which is that a corporation's tax obligations to a state should be balanced with the benefits it receives from public services provided by the state. For example, BATSA immunizes a corporation with 100 employees in a state for 14 days from all BATs, while a corporation with just one employee in the state for 15 days could be required by a state to pay the BAT. Clearly, the first corporation is benefiting more from police, fire, transportation, and other services provided to its employees than is the second corporation, and yet it is the first corporation that BATSA exempts from taxation.

- The other safe harbors in BATSA are just as illogical and inconsistent with the fundamental rationale offered for the bill. For example, having a million dollar's worth of inventory in a state that is being stored at an order-fulfillment warehouse run by a business like UPS or Federal Express does not create nexus under BATSA, but owning a building in the state that is worth a million dollars does create nexus. There is no reason to believe that the value of police and fire protection being provided to both types of property is any different, yet one type of property creates nexus under BATSA and the other doesn't.

Claim:

Public Law 86-272 was enacted by Congress in 1959 and decrees that a state may not impose a corporate income tax on an out-of-state business whose only activity within the state is soliciting sales of tangible goods (including through the use of a traveling salesforce), if the orders are fulfilled from an out-of-state shipment point. BATSA is needed to "modernize" P.L. 86-272 by extending it to all BATs and to sales of services in addition to sales of goods.

Rebuttal:

- P.L. 86-272 was intended to be a temporary measure to hold a 1959 Supreme Court decision in abeyance. That decision signaled the end of a now completely discarded Supreme Court doctrine holding that states couldn't tax interstate commerce at all. P.L. 86-272 is an obsolete nexus law that violates the core rationale offered for BATSA: that only physically-present businesses should be subject to a BAT because only such businesses benefit from public services. P.L. 86-272 violates this principle because it allows a corporation to have an unlimited number of salespeople in a state and an unlimited amount of goods en route to customers in an unlimited number of company-owned trucks and yet still not create corporate income tax nexus. P.L. 86-272 should be repealed, not broadened, even under a true "physical presence" nexus standard. Its extension to sales of services and other BATs would be the opposite of "modernization."

- Extending P.L. 86-272 to the sale of services would be problematic and likely to spawn considerable litigation. In the case of a sale of goods, it is possible to draw the line between in-state solicitation of an order and fulfillment of the order from an out-of-state origination point with reasonable objectivity. That will not be true with the sale of services in many instances. For example, if a credit card holder uses her card to borrow cash from an out-of-state bank at an in-state ATM machine, is the service "fulfilled" in-state where the cash is delivered (which the state is likely to assert) or out-of-state at the credit card company's computer server that electronically "authorizes" the loan (which the bank is likely to assert)? Costly litigation will have to resolve many such questions if BATSA extends P.L. 86-272 to sellers of services.

Claim:

Many states take the position that if a corporation engages in solicitation or other market-enhancing activity within its borders on behalf of an out-of-state corporation, that creates nexus for the out-of-state corporation. BATSA is needed to stop states from aggressively and unfairly seeking to "attribute" nexus from one corporation to another in this manner. "Attributional nexus" is unfair and unreasonable because the state can tax the income of the in-state corporation and shouldn't be allowed to tax the income of the out-of-state corporation as well. Therefore, BATSA appropriately provides that the "market-creating" and "market-maintaining" activities of an in-state agent never establish nexus for the out-of-state company on whose behalf the agent is working if the agent represents at least two different clients.

Rebuttal:

- The U.S. Supreme Court upheld the fairness of "attributional nexus" for BATs in a decision issued more than 20 years ago.[8] In an even earlier sales tax nexus case, the Court observed that allowing a corporation to avoid nexus in a state by having "independent contractors" act on its behalf rather than using its own employees "would open the gates to a stampede of tax avoidance."

- The provision of BATSA blocking "attributional nexus" seeks to undermine the fundamental and longstanding operation of state corporate income taxes. Such taxes do not seek to divide marketing activities conducted in one state from production activities conducted in another. Rather, once a manufacturer (for example) establishes nexus in a state, that state taxes an apportioned share of the nationwide activities of the business, from the purchase of raw materials up to and including the final sale of the product to the ultimate customer. Under such a system, it makes no sense to bar a state from being able to tax a share of the profit earned from the manufacturing activities merely because the in-state marketing activities were conducted by a third party rather than the manufacturer's own employees. Even worse, under BATSA the "market-creating" activities could be conducted by a wholly-owned and controlled subsidiary of the manufacturer and not create nexus for the latter, if the goods were produced by two nominally separate subsidiary corporations. (See: www.cbpp.org/6-24-08sfp.pdf, p. 4.)

Claims About Alleged Harms that the Enactment of BATSA Will Stop

Claim:

By establishing a clear, nationally-applicable, physical-presence nexus standard, BATSA will substantially reduce the amount of nexus-related litigation that is occurring.

Rebuttal:

- BATSA contains numerous undefined terms that will generate considerable litigation, just as P.L. 86-272 has generated — and continues to generate — substantial litigation. For example, BATSA includes a provision declaring that nexus is not created by the in-state "conduct [of] limited or transient business activity" with no definition of "limited" or "transient." Because

Congress failed to define the key "safe harbor" provision in P.L. 86-272 — "solicitation" — constant litigation occurred for more than 30 years until the U.S. Supreme Court accepted a case that offered some (minimal) guidance. BATSA will generate even more litigation than P.L. 86-272 did, because it is a much more far-reaching and complex bill.

- A comprehensive law review article documented 57 reported court cases involving disputes over the application of P.L. 86-272 as of 2003, and occasional cases have occurred since.[9] BATSA proponents can cite approximately 20 BAT nexus cases that do not involve P.L. 86-272.[10] Thus, the claim of BATSA proponents that "Public Law 86-272 has generated relatively few cases, perhaps a score or two . . . [while] areas outside its coverage have been litigated extensively" is false.

- As documented in the Center's analysis of BATSA, enactment of the bill will open up enormous opportunities for corporations to shelter their profits from taxation in many of the states in which they are earned. As a result, states will have no alternative but to use every legal means at their disposal to protect their tax bases. BATSA therefore will not reduce litigation between states and taxpayers, but — at best — merely displace it from nexus cases to cases challenging the use of these "fallback" approaches. For example, many states have discretionary authority to treat in-state and out-of-state subsidiaries for tax purposes as if they are one corporation but rarely use it because its exercise is almost always challenged in court. Because of the damage that will be done by BATSA to their revenues, states are more likely to use this authority, with additional litigation resulting.

- The enactment of BATSA will not bring nationwide uniformity to nexus law. BATSA's provisions will be interpreted by state courts and, just as occurred under P.L. 86-272, state courts will reach different conclusions about what the provisions mean. Only a U.S. Supreme Court decision interpreting BATSA can provide a measure of national nexus law uniformity, and in the more than 50 year history of P.L. 86-272, the Court has accepted a single appeal from a state P.L. 86-272 case of general applicability.[11]

Claim:

BATSA is needed to prevent "double taxation" of corporate income, which is burdening corporations and stifling commerce.

Rebuttal:

- Proponents of BATSA have not provided any concrete examples of corporations subject to double taxation of their income. In fact, as explained in another Center report, BATSA is likely to have just the opposite effect, vastly increasing the share of U.S. corporate profit that is "nowhere income" not subject to tax by *any* state. (See: www.cbpp.org/12-13-05tax.htm.)

- Restricting state taxing jurisdiction is an unnecessary and excessive mechanism for preventing double taxation of corporate income in any case. The potential for such double taxation can be substantially eliminated by states adopting uniform "apportionment" rules governing the division among the states of the profits of multistate corporations. Yet, as documented in the report cited in the previous paragraph, many BATSA proponents have been instrumental in pushing states toward non-uniformity in their apportionment rules. In short, offering "double taxation" as a justification for BATSA is both unsupported by facts and hypocritical.

Claim:

BATSA is needed to prevent "taxation without representation." Businesses have no political representation or influence in states in which they have no physical presence and will be subjected to unfair tax burdens if they are subject to taxation in such states.

Rebuttal:

- This argument has been forcefully rebutted by leading state tax experts Walter Hellerstein of the University of Georgia Law School and Charles McLure of Stanford University's Hoover Institution.[12] They note that corporations don't have the right to vote. In addition, states have an unquestioned right to tax the income earned within their borders and property owned there by non-resident *individuals* who also don't have the right to vote in states in which they are subject to taxation. In short, "no taxation without representation" as an argument for BATSA is a red herring.

- Hellerstein and McLure also observe that because the courts have made clear that states may not discriminate in their tax policies against out-of-state businesses, lobbying by in-state businesses (which clearly do have significant political influence in a state) against onerous tax policies also protects the interests of out-of-state businesses.

Claim:

There is a disturbing trend of states raising revenues through aggressive assertion of nexus over out-of-state companies with little or no presence within their borders, which the states then use to finance economic development tax breaks to corporations that do have substantial property or employees within the state. BATSA is needed to put a stop to such discrimination in favor of in-state firms at the expense of out-of-state firms.

Rebuttal:

This is an ironic argument for BATSA proponents to make:

- A number of corporations supporting BATSA have worked actively for an increasingly common change in state tax policy that, in the name of economic development, is explicitly aimed at shifting the corporate income tax burden off of corporations with a substantial physical presence in a state and onto out-of-state corporations with little physical presence in a state. (See: www.cbpp.org/1-26-05sfp.htm.) For example, Bayer Corporation, Dick's Sporting Goods, General Electric, The Walt Disney Company, and Johnson & Johnson are members of coalitions that have actively lobbied for this policy (a "single sales factor apportionment formula") in Pennsylvania and California.[13]

- Many business organizations supporting BATSA also sought the enactment of the "Economic

Development Act of 2005" (S. 1066/H.R. 2471). The goal of this bill was to preserve existing state economic development tax incentives. The EDA was aimed at stopping challenges to tax incentives based on the argument that they discriminate against out-of-state businesses in violation of the Constitution's Commerce Clause. In other words, the many BATSA proponents that also supported the EDA tried to *preserve* the right of states to discriminate in favor of in-state businesses by providing them with tax breaks.

- BATSA itself has one provision that intentionally discriminates against certain out-of-state businesses in the name of state economic development. In order to help states drum-up business for in-state corporations from out-of-state corporations, BATSA declares that physical presence in a state in connection with being a *purchaser from* an in-state business is not nexus-creating. This provision discriminates against out-of-state businesses that may have an equivalent number of employees or an equivalent amount of property in a state but will not be protected by BATSA from state taxation because that physical presence is involved in *selling to* an in-state business.

Claim:

The aggressive efforts of state tax administrators to assert nexus over corporations that merely have customers within their borders are creating enormous uncertainty for these businesses about their BAT payment obligations. This uncertainty is "chilling. . . interstate economic activity," encouraging U.S. corporations to invest abroad rather than here, and discouraging foreign corporations from investing in the United States.

Rebuttal:

- BATSA proponents substantially exaggerate both the nexus enforcement efforts of state tax officials and the uncertainty surrounding the state of BAT nexus law. There is no uncertainty about the nexus rules that apply to businesses that conduct the vast majority of transactions in the U.S. economy. P.L. 86-272 governs the application of state corporate income taxes to sellers of physical goods, and state tax officials can't get around it no matter how "aggressive" they might like to be in theory. Where P.L. 86-272 doesn't apply, there is little ambiguity in practice, because the majority of transactions are made with some in-state physical presence of the selling corporation (which clearly creates nexus). The majority of court cases and enforcement actions that have been initiated by states to compel income tax payments by allegedly non-physically-present corporations have been aimed at nullifying a single, abusive tax shelter that, in fact, relies on the physical presence within the state of the out-of-state corporation's trademark.[14]

- In the 11 years that BATSA has been under consideration in Congress, and with all the millions of businesses operating in the United States, BATSA proponents have managed to come up with a single, concrete example of a company that allegedly has decided not to make cross-border sales into a (single) state because of the state's assertion of nexus over it, despite its lack of physical presence within the state.[15] The isolated small service business aside, it is highly implausible that large, national businesses are constraining their own growth by deciding not to do business in particular states because of BAT nexus issues. Where are the examples of national fast-food chains that refuse to license franchisees in particular states because of fears of assertion of nexus over the franchisor? Where are the examples of national banks that won't issue credit cards to residents of particular states because of nexus concerns? Until such examples are provided and documented, claims that interstate commerce — and therefore job growth— is being significantly stifled by concerns about creating BAT nexus in additional states should not be given any credence.

- If anything, the enactment of BATSA is likely to harm the economy by providing a *disincentive* for optimal business location decisions. As the former Director of the Oregon Department of Revenue has argued:

  > [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[16]

  BATSA proponents argue that the bill is needed to prevent "aggressive" state assertion of nexus from stifling interstate commerce, which they suggest is synonymous with interstate *sales*. They completely fail to acknowledge that interstate commerce also encompasses interstate *investment and job creation*, and that BATSA has the potential to discourage this by creating an artificial, tax-based incentive for corporations to tap into the consumer market in a state without placing facilities and jobs within the state's borders.

- This same logic undermines the (unsubstantiated) claims that nexus uncertainty is encouraging U.S. businesses to produce abroad and discouraging foreign direct investment in the United States. If anything, it is much more likely that the enactment of BATSA would have these effects. BATSA would allow both foreign subsidiaries of U.S.-based corporations and foreign-based corporations to conduct more activities in the United States to "establish and maintain" their markets here without creating BAT nexus. This could encourage them to fulfill U.S. demand for their goods and services through export from foreign factories and other facilities rather than produce those goods and services here with American workers. Moreover, the data on foreign direct investment do not substantiate the claim that BAT nexus "uncertainty" is putting a "real damper" on foreign direct investment here. While such investment fluctuates enormously from year to year and remains below the peak year of 2000, it rose steadily from 2002 through 2008. For 2008, foreign direct investment in the United States remained well above the level of the early 1990s, when a few states began to enforce the allegedly aggressive, "economic presence" approach to defining nexus.[17]

Claim:

If the state nexus threshold for the imposition of a BAT is not raised at least as high as the provisions of BATSA, the U.S. economy and U.S. corporations are at substantial risk of retaliation from foreign governments that are angry that corporations headquartered in their nations can have income tax nexus in a state without having a "permanent establishment" in the United States. Foreign governments might also seek to renegotiate their tax treaties with the United States to eliminate the PE threshold. This would free them to impose their national-level corporate income taxes on non-physically-present U.S. corporations, just as states are imposing their income taxes on non-physically-present foreign corporations. Thus, "[e]nactment of BATSA, which includes a nexus standard that is analogous to those found in U.S. tax treaties, is essential for ensuring that the current international system of taxation remains intact."[18]

Rebuttal:

- BATSA proponents have presented no evidence to back up their claim that the United States is at risk of economic harm due to retaliation from foreign governments angered by state nexus standards that differ from "permanent establishment" rules. To the contrary, a report issued periodically by the European Union details U.S. federal and state policies that the EU views as trade barriers but makes no mention of state nexus standards — even as it does object to other state tax practices.[19]

- State nexus thresholds have been far lower than the PE standard for decades. There is no evidence that foreign governments have ever actively sought to renegotiate the tax treaties to eliminate the PE rules so that they could apply their national-level taxes to non-physically-present corporations in retaliation for state nexus thresholds that are lower than the PE rules. In any case, the federal government would be under no compulsion to accept a demand from foreign treaty partners that the PE standard be eliminated.

Notes

[1] Two leading experts on state taxation concur:

> This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible. A profitable corporation clearly enjoys both types of benefits. It is true that in-state corporations may receive greater benefits than their out-of-state counterparts, for example, because they have physical assets that need fire and police protection. But that is a question of the magnitude of the benefits and the tax that is appropriate to finance them – something that is properly addressed by the choice of apportionment formula and the tax rate, not the type of yes/no question that is relevant for issues of nexus. The answer must clearly be a resounding yes to the question of whether the state has given anything for which it can ask in return.

Charles E. McLure Jr. and Walter Hellerstein, "Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals," *State Tax Notes*, March 1, 2004, p. 721. The article was sponsored by the National Governors' Association. McLure is a Senior Fellow with the Hoover Institution at Stanford University and was Deputy Assistant Secretary of the Treasury for Tax Analysis during the Reagan Administration. Walter Hellerstein is Francis Shackelford Professor of Taxation at the University of Georgia Law School and author of the most well-known legal treatise on state taxation.

[2] It is true that the *Whitney* and *International Harvester* cases focused on whether New York and Wisconsin, respectively, had the right to tax the income of the out-of-state recipients rather than assert taxing jurisdiction over the recipients themselves. It is also true that both cases were decided before *Quill* articulated a novel legal principle that the Due Process and Commerce Clauses of the Constitution imposed their own — and different — nexus requirements for state taxation of out-of-state corporations. Nonetheless, given the Court's explicit statements in *Quill* that its earlier cases had not established a physical presence nexus threshold for taxes other than the sales tax, it arguably is more likely than not that states have the authority under current constitutional law, at least in certain circumstances, to impose business activity taxes on income earned by non-physically-present companies.

That conclusion was supported by the late Jerome Hellerstein, widely recognized as one of the preeminent experts of the last 50 years on constitutional law bearing on state taxing authority. In an article written *after* the *Quill* decision, he stated: "The U.S. Supreme Court has made it clear that the presence of the recipient of income from intangible property in a state is *not* essential to the state's income tax on income of a nonresident."

In short, the Supreme Court determined long ago that, at least in certain circumstances, it is entirely fair for a state to tax the income earned within its borders by a non-physically-present person or business.

[3] Courts in Illinois, Iowa, Louisiana, Maryland, Massachusetts, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina, and West Virginia have held that physical presence is not required for BAT nexus. Courts in Tennessee and Texas have held that it is. A Missouri case cited by BATSA proponents as supporting their position was decided on state law grounds having nothing to do with nexus under the Constitution. An Alabama case they also cite was effectively reversed by a subsequent decision.

[4] The six most recent decisions in Iowa, Massachusetts, New Jersey, North Carolina, Oklahoma, and West Virginia have all sided with the states' positions that a business need not be physically present in a state to have BAT nexus there. The Massachusetts, New Jersey, North Carolina, and West Virginia cases were all appealed to the U.S. Supreme Court, which declined to hear them.

[5] See a letter dated November 11, 1995 from Fred E. Ferguson of Arthur Andersen representing the Financial Institutions State Tax Coalition to the Chairman of the Multistate Tax Commission in support of the proposed financial institutions apportionment regulation. The letter states: "The FIST Coalition believes that the Apportionment Rules should serve as the model for uniform state apportionment of income of financial institutions. We encourage the MTC to adopt the rules, recommend that its member states favorably consider the rules for adoption, and urge the MTC to seek uniform adoption among non-member states as well." The rules FIST endorsed included provisions assigning receipts from interest to the states in which a bank's borrowers are located. Members of the FIST Coalition named in the letter include Citicorp/Citibank and Bank of America, both of which now support BATSA. See also a letter dated

April 16, 1990 from Ruurd Leegstra of Price Waterhouse to the MTC's General Counsel accompanying a "Proposal of the Broadcasters" dated April 13, 1990 and drafted by the ABC and NBC networks. The proposal included a provision apportioning advertising receipts of radio and television broadcasters based on the location of listeners/viewers. Both letters are on file in the headquarters office of the MTC.

[6] See: OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?* Final Report, 2006. For example, see paragraphs 43, 44, 51, and 120.

[7] See the source cited in the previous note. "For the [task force], fundamental changes should only be undertaken if there was a broad agreement that a particular alternative was clearly superior to the existing rules and none of the alternatives that have been suggested so far appears to meet that condition. The need to refrain from fundamental changes unless clearly superior alternatives are found is especially important since any attempt to change the fundamental aspects of the current international rules for taxing business profits would create difficult transition rules given the fact that many countries would likely disagree with such changes and that a long period of time would be required for the gradual adaptation of the existing network of tax treaties."

[8] *Tyler Pipe* v. *Washington*, 1987. In *Tyler Pipe*, the Court held that hiring an independent representative in a state to solicit sales and conduct other activities that helped an out-of-state corporation create and maintain a market for its products was no different from having an employee in a state engaged in the same activities and did indeed establish BAT nexus for the out-of-state corporation. There was no suggestion whatsoever in the case that the holding would have been any different if the in-state representative had solicited sales on behalf of more than one out-of-state company; indeed, the evidence strongly suggests that it did. The *Tyler Pipe* decision of the Washington State Supreme Court, which the U.S. Supreme Court reviewed, states that the Washington representative of Tyler Pipe was Ashe and Jones, Inc. of Seattle. Ashe and Jones was characterized by Tyler Pipe as an independent contractor, suggesting that it solicited Washington sales on behalf of multiple out-of-state businesses. Ashe and Jones appears to have been at that time a typical "manufacturers' representative" firm with multiple clients. The company certainly has multiple clients today, including Tyler Pipe. See: www.alliancesalesnw.com/alliancesalesnw_002.htm.

[9] Bradley W. Joondeph, "Are State Courts Biased Against Taxpayers that Seek the Protection of Federal Law?" *State Tax Notes*, October 27, 2003. Cases interpreting the application of P.L. 86-272 since 2003 include *Alcoa Building Products* v. *Mass. Commissioner of Revenue* (2003), *Asher* v. *N.J. Division of Taxation* (2005), and *Inova Diagnostics, Inc.* v. *Texas Comptroller of Public Accounts* (2005).

[10] See, for example, footnotes 16 and 17 of the letter to the House Judiciary Committee Subcommittee on Commercial and Administrative Law in support of BATSA from the Coalition on Rational and Fair Taxation dated April 13, 2011. Those footnotes identify 13 cases litigated since the *Quill* decision. There have been about 10 additional cases not listed there in Louisiana, Oklahoma, Iowa, and Washington.

[11] See: *Wisconsin Dept. of Revenue.* v. *William Wrigley, Jr., Co.*, 1992. In 1972 the Supreme Court had heard a case on a very narrow issue involving the interaction between Public Law 86-272 and state regulation of the sale of alcohol.

[12] See the source cited in Note 1, p. 735.

[13] Bayer Corporation, General Electric, Johnson & Johnson, and Dick's Sporting Goods were members of the "CompetePA" coalition lobbying for the so-called "single sales factor apportionment" incentive in Pennsylvania. See: www.alleghenyconference.org/competepa/PDFs/CompetePACoalitionMembers.pdf.

Johnson & Johnson and Walt Disney were members of the "Coalition for a Competitive California" lobbying for single sales factor legislation there. See "Report of Lobbying Coalition" for the first quarter of 2008, available at cal-access.ss.ca.gov/Misc/pdf.aspx?filingid=1326354&amendid=0. The latter two companies also funded the "No on 24" campaign in the fall of 2010 opposing a ballot measure that would have repealed California's single sales factor law. All five of these companies were signatories to a June 12, 2008 letter in support of BATSA sent to Representative John Conyers, then the Chair of the House Judiciary Committee.

[14] For a description of how this "intangible holding company" tax shelter operates, see p. 5 of the Center's analysis of BATSA, available at www.cbpp.org/6-24-08sfp.pdf.

[15] See the testimony of Carey J. Horne on pp. 9-13 of the September 27, 2005 hearing on H.R. 1956 before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee. H.R. 1956 was the version of BATSA introduced in the 109th Congress.

[16] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001.

[17] See: Thomas Anderson, "Foreign Direct Investment in the United States: New Investment in 2008," *Survey of Current Business*, June 2009, p. 54. The first high-profile attempt by a state to enforce an "economic presence" nexus standard against a Delaware trademark holding company was the *South Carolina* v. *Geoffrey* case decided by the South Carolina Supreme Court in 1993.

[18] See the source cited in Note 10.

[19] See: European Commission, "United States Barriers to Trade and Investment, Report for 2008," July 2009, p. 68.

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PROPOSED "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION WOULD SERIOUSLY UNDERMINE STATE TAXES ON CORPORATE PROFITS AND HARM THE ECONOMY

By Michael Mazerov

A bill recently reintroduced in the U.S. House of Representatives would strip states of their current authority to tax a fair share of the profits of many corporations that are based out-of-state but do business within their borders. Representative Bob Goodlatte reintroduced the "Business Activity Tax Simplification Act" ("BATSA"), H.R. 1439, on April 8, 2011. The Subcommittee on Commercial and Administrative Law of the House Judiciary Committee held a hearing on the bill on April 13.

BATSA defines many activities that corporations commonly conduct within a state as being no longer sufficient to obligate the corporation to pay several different kinds of taxes to the state (or to its local governments). Moreover, it defines these "safe harbors" from taxation in a highly ambiguous, arbitrary and inconsistent manner. These new restrictions on state and local taxing authority would have far-reaching, adverse impacts on the revenue-generating capacity and fairness of state and local tax systems. The most significantly affected taxes would be corporate income taxes levied by 44 states, the District of Columbia, and New York City. If enacted, BATSA would have the following effects:

- The legislation would cause state and local governments collectively to lose substantial tax payments from out-of-state corporations that would be freed from their current obligations to pay taxes on their profits and gross sales to particular jurisdictions. A significant share of currently-taxable corporate profits would go untaxed by *any* state, leading to a net revenue loss for the states as a whole. According to a Congressional Budget Office estimate done in 2006 on a substantially similar version of the bill, state revenue losses would grow to $3 billion annually within five years of enactment.

  States have already suffered massive loss of revenues as a result of the recession and slow recovery. Additional loss of revenue in the next few years would undermine state funding for education, health care, public safety, infrastructure, and other services important for states' long-term prosperity.

- BATSA would block particular states from taxing particular corporations on income earned in those states. Even if those corporations' profits might ultimately be taxed by their home states, BATSA still would unfairly deprive other states and localities of their right to tax the profits of specific out-of-state corporations that benefit from services these jurisdictions provide.

- BATSA would stimulate a wave of new corporate tax sheltering activity aimed at cutting state and local business tax liabilities, which would stimulate demand for tax lawyers and accountants but reduce economic productivity and competitiveness.

- The legislation would mire state and local governments and corporations alike in a morass of litigation over whether particular businesses are or are not protected from taxation under the numerous vaguely-defined provisions of BATSA — another outcome that would benefit lawyers and accountants at the expense of everyone else.

- BATSA would reward major multistate corporations that have the resources to engage in aggressive tax-avoidance behavior with much lower tax burdens than their small, locally-oriented competitors, thereby handing small businesses a competitive disadvantage.

For example, if BATSA were enacted:

- A television network would not be taxable in a state even if it had affiliate stations and local cable systems there relaying its programming and regularly sent employees into the state to cover sporting events and to solicit advertising purchases from in-state corporations.

- A bank would not be taxable within a state even if it hired independent contractors there to process mortgage loan applications and the loans were secured for homes located within the state.

- A restaurant franchisor like Pizza Hut or Dunkin' Donuts would not be taxable in a state no matter how many franchisees it had in the state and no matter how often its employees entered the state to solicit sales of supplies to the franchisees or to train the franchisees in company procedures.

These are just a few examples of the types of corporations that would be protected from state corporate income taxes by the provisions of BATSA. That corporations engaging in such extensive in-state activities would be immunized from taxation suggests why a congressionally-imposed business activity tax (BAT) nexus threshold even loosely based on the current text of BATSA would be a prescription for further litigation, inequity among businesses, and erosion of a vital source of funding for state and local services.

A compelling case for tighter federal limits on the authority of states to impose business activity taxes on out-of-state corporations has not been made. If, nonetheless, Congress decides to act in this area, workable and fair alternatives to BATSA are available. A proposed taxing jurisdiction (or "nexus") standard developed by the Multistate Tax Commission, for example, would base taxing authority on relatively objective measures of the dollar amount of a business' sales occurring in a state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.[1] Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a business activity tax on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

What Would BATSA Do?

BATSA would impose what is usually referred to as a federally-established "nexus" threshold for state (and local) BATs. State taxes on corporate profits are the most widely-levied state business activity taxes.[2] The term also encompasses such broad-based business taxes as the New Hampshire Business Enterprise Tax (a form of value-added tax), the Washington Business and Occupations Tax and the Ohio Commercial Activities Tax (both are taxes on businesses' gross sales), and the Texas Franchise Tax (a modified gross sales tax). The "nexus" threshold is the minimum amount of activity a business must have in a particular state to become subject to taxation in that state.

Nexus thresholds are defined in the first instance by state law. State business tax laws set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have "created" or "established" nexus with the state, and it therefore must file a tax return and pay any tax that may be due. Federal statutes can invalidate state nexus laws, however, and BATSA proposes to do just that.

BATSA proponents claim that the bill would impose a "bright-line," physical presence requirement for BAT nexus.[3] This claim implies that if a corporation has a physical presence in a state, it could be subjected to a BAT by that state. In reality, the bill would create a plethora of exceptions to a physical presence standard. Many types of clear and substantial physical presence in a state that establish nexus for a business under current state and federal law would no longer be sufficient to obligate the business to pay a BAT to the state. For example, a corporation would no longer have nexus in a state under BATSA even if it had dozens of employees in the state negotiating purchases of supplies for the business or a million dollars worth of inventory in the state being stored at a third-party warehouse for local delivery on demand to its customers. There is no question that such substantial physical presence in a state would establish BAT nexus for the corporation under current law.

In 1959, Congress enacted a BAT nexus threshold that was intended to be temporary (but was never repealed) and that covered just two limited categories of in-state business activity. Public Law 86-272 bars a state from taxing the profits of an out-of-state corporation selling physical products if the business' activities within the state are limited to soliciting orders for those products (using the mail, telephones, the Internet, or traveling salespeople) and delivering them into the state from an out-of-state origination point. BATSA would vastly expand the reach of P.L. 86-272 by:

- extending it to the entire service sector of the economy; and
- extending it from income taxes to all business activity taxes; and
- establishing numerous new "safe harbors" from nexus (while retaining the safe harbors for in-state solicitation and delivery). For example, under BATSA a corporation could have an unlimited number of employees or an unlimited amount of equipment or other property in a

state for up to (and including) 14 days per year without establishing BAT nexus.

(The Appendix to this report contains a more detailed discussion of the provisions of BATSA and the specific types of corporations and business activities it would exempt from state and local business activity taxes. The Appendix is available at www.cbpp.org/6-24-08sfp-appendix.pdf.)

Adverse Impacts of BATSA on State Finances and Corporate Tax Fairness

Replacing existing nexus laws with the nexus threshold contained in BATSA would have a number of serious adverse consequences for state finances and tax fairness:

- *Substantial loss of state corporate tax revenue in the aggregate.* BATSA would cause a large majority of states to lose substantial corporate profits tax payments (and other BAT payments as well) from out-of-state corporations that would no longer be subject to tax because of the higher nexus threshold that would be established by the bill. The untaxed profits frequently would not be taxed by the state(s) in which the corporations remained taxable, either, leading to a substantial net loss of corporate tax revenue for states in the aggregate.

  - *Example.* A Maryland-based industrial equipment manufacturer takes its orders over the Internet but has nexus in every state in which it has customers because its employees install that equipment at its customers' place of business. Under BATSA, this manufacturer could easily arrange to have corporate income tax nexus only in Maryland. The bill provides that the use of an agent in a state does not create nexus so long as the agent has more than one client. The clients may be related to the agent through common ownership. The manufacturer could bring itself under this safe harbor by forming one subsidiary to employ the equipment installers and two others to manufacture the equipment (say, one subsidiary to manufacture Product A and another to manufacture Product B). Such a restructuring would make the installation subsidiary the agent of two legally-distinct manufacturer "clients." This would satisfy the terms of the "safe harbor" in BATSA and block all states except Maryland from taxing the corporation's profit from equipment sales. Because of how Maryland taxes the profits of multistate corporations, none of the corporation's profit earned on equipment sales made to non-Maryland customers would be taxable in Maryland, either — meaning that this corporation's total tax payments to the states taken together likely would drop precipitously.[4] Multiply this scenario by thousands of businesses in scores of states, and it becomes clear that the aggregate loss of state corporate income tax revenue would be substantial.

  In 2006, the Congressional Budget Office estimated that the enactment of BATSA would lead to lost revenues "to state and local governments [that] would exceed $1 billion in the first full year after enactment and . . . likely grow to about $3 billion, annually, by 2011."[5]

- *Individual states deprived of their fair share of tax revenue.* Regardless of whether BATSA enabled a particular corporation to pay less business activity tax in total, the bill would deprive individual states of their fair share of taxes from out-of-state corporations earning profits within their borders and benefiting directly from public services the states provide.

> *Example.* A Massachusetts bank makes home mortgage loans to Connecticut borrowers who apply for the loans over the Internet or during an in-home visit by an independent mortgage broker engaged by the bank. The borrowers go to settlement at a Connecticut title company of their choice. BATSA would block Connecticut from taxing the bank's profits on those loans: the bank has no employees and owns no property in Connecticut, and its use of Connecticut brokers and settlement agents does not create nexus because the companies provide these services to multiple banks. Connecticut is barred from taxing any of the bank's profits on Connecticut home loans despite the fact that the banks use Connecticut's courts to foreclose on delinquent loans and the value of the homes that serve as mandatory collateral for the loans is crucially dependent on the quality of local schools, parks, roads, and police and fire protection provided by Connecticut and its local governments. Under provisions of Massachusetts' bank taxation law, Connecticut's inability to tax the bank likely would result in the bank's paying tax on profits from the Connecticut loans to Massachusetts instead.[6] Nonetheless, BATSA would deny Connecticut its fair share of tax on profits earned within its borders by a corporation that is benefiting from public services Connecticut provides to the bank, the bank's collateral, and the bank's in-state settlement agents.

- *Hamstringing state efforts to stop abusive tax sheltering.* BATSA would block states from asserting corporate income tax nexus over out-of-state companies that license trademarks to related in-state businesses. This would deprive states of a key tool they are using to shut down perhaps the most abusive state corporate tax shelter in widespread use.

> *Example.* Under a tax shelter employing a so-called "intangible holding company" (IHC), a corporation operating retail stores like The Limited transfers its trademarks to a subsidiary corporation it has created in a tax-haven state like Delaware or Nevada. The stores then pay royalties to this subsidiary for the use of the trademarks. These royalties are tax-deductible (as a cost of doing business) and hence can be used to largely or entirely eliminate corporate income tax liability in the states in which the corporation is actually doing business and earning its profits.[7] Meanwhile, the royalty payments are not taxed by the tax-haven state. Three-fourths of the states with corporate income taxes seek to nullify this tax shelter by asserting that the IHC is directly taxable in any state from which it receives royalties.[8] BATSA would close off this avenue of attack on IHCs by providing that the presence in a state of an intangible asset like a trademark does not create BAT nexus for the out-of-state corporation that owns it. In so doing, BATSA would reverse court decisions in Louisiana, Maryland, Massachusetts, New Jersey, New Mexico, North Carolina, Oklahoma, and South Carolina that held that IHCs had nexus in those states, as well as repeal the nexus policy of some 25 additional states.[9]

(While states can amend their tax laws to implement alternative approaches to nullifying the IHC tax shelter, multistate corporations have blocked enactment or watered down such laws in many states.[10] In contrast, most states can assert nexus over the out-of-state owner of the trademark under their existing BAT nexus laws — laws which BATSA would invalidate.)

- *Opening up vast new tax-avoidance opportunities.* BATSA would open up enormous new opportunities for corporations to shelter their profits from taxation in states in which the profits are earned by dividing themselves into separate legal entities (such as a parent corporation and several subsidiary corporations). For example, the bill provides that a corporation can send an unlimited number of employees and an unlimited amount of equipment into a state without establishing BAT nexus so long as the employees and equipment are not in the state for more than 14 days in a calendar year. However, this 14-day limit — like all the "safe harbors" from nexus in BATSA — applies separately to every individual corporation in a multi-corporate group.

- *Example.* A business providing on-site computer repair and troubleshooting services needs to have employees in a neighboring state an average of 180 days per year. However, it would like to avoid triggering BAT nexus in the neighboring state because the corporate tax rate in its home state is lower. The company could achieve both objectives with modest legal and accounting costs by incorporating 13 different subsidiaries to employ its repairmen and rotating responsibility for providing service in the neighboring state among those subsidiaries at 14 day intervals. If the company were too small to employ 13 repairmen, it could rotate their employment among the subsidiaries as well.

In a 2008 report, the Congressional Research Service concurred that the enactment of federal BAT nexus legislation like BATSA would lead to increased corporate tax avoidance:

> [BATSA] would increase opportunities for tax planning and thus tax avoidance and possibly evasion. In addition, expanding the *types* of activities that are covered by P.L. 86-272 would also expand the opportunities for tax planning.[11]

Adverse Impacts of BATSA on the Economy

Enactment of BATSA also would adversely affect the economy.

- *Degraded public services.* As noted above, the Congressional Budget Office has concluded that the enactment of BATSA would cause state and local governments to lose approximately $3 billion in annual revenues once corporations have an opportunity to restructure their operations to take advantage of the tax-sheltering opportunities the bill creates. By depriving states of business activity tax revenues they currently are collecting, the legislation could further impair their ability to provide services that are a critical foundation of a healthy national economy — such as high-quality K-12 and university education and transportation infrastructure.

- *Costly litigation.* The U.S. Supreme Court's 1992 *Quill* decision reaffirmed a 1967 decision that established "physical presence" as the nexus threshold for state *sales* taxes.[12] Far from being the "bright line" nexus standard sought by the Court, litigation on the meaning of "physical presence" has continued unabated since *Quill*.[13] BATSA not only would re-create these conflicts in the BAT arena, but it would also create new areas of litigation because it contains numerous ambiguous definitions whose meaning could only be resolved by courts. Given the substantial new limitations placed on their revenue-raising ability by BATSA, states and localities would have no choice but to engage in widespread litigation aimed at establishing the narrowest-possible interpretation of the nexus "safe harbors" contained in the law. Such litigation would waste the limited financial and human resources of taxpayers and tax administrators alike.

- *Example.* BATSA provides that having employees or property in a state in order to conduct "limited or transient business activity" does not create nexus. Neither "limited" nor "transient" is defined in BATSA. An exemption for "limited" activity could imply that a business will not be taxable in a state if it does not engage in the full range of activities involved in its business; for example, a manufacturer might not be taxable in a state in which it had a sales office but not one of its manufacturing plants. An exemption for "transient" presence means that a business might never be taxable in a state its employees entered temporarily no matter how many days per year they spent there. Given this ambiguity and the enormous revenue consequences for the states flowing from how just these two terms in BATSA might be interpreted, their enactment into law would be a prescription for constant litigation until the Supreme Court supplied some measure of clarity. In the case of the meaning of the term "solicitation" in P.L. 86-272, that was a period of more than *30 years.*

- *Economically sub-optimal business location decisions.* A physical presence nexus threshold may interfere with the efficient allocation of economic resources by creating an artificial disincentive for the placement of facilities in states where fundamental economic considerations might otherwise dictate they should be located. As a former Director of the Oregon Department of Revenue has argued:

  > [I]n an era when companies can make substantial quantities of sales and earn substantial income within a state from outside that state, the concept of "physical activity" as a standard for state taxing authority [nexus] is inappropriate. . . . If a company is subject to state and local taxes only when it creates jobs and facilities in a state, then many companies will choose not to create additional jobs and invest in additional facilities in other states. Instead, many companies will choose to make sales into and earn income from the states without investing in them. If Congress ties states to physical activity concepts of taxing jurisdiction, Congress will be choosing to freeze investment in some areas and prevent the flow of new technology and economic prosperity in a balanced way across the nation.[14]

  - *Example.* Jeff Bezos, the CEO of Amazon.com, has acknowledged that he would have preferred to establish his company in California rather than Washington but did not do so in order to avoid having to charge sales tax to the large customer market located in California.[15] Had Amazon.com been obligated to charge sales tax to California customers regardless of whether it was physically present in that state, Bezos would not have had an incentive to establish the company in a less-than-ideal location. A physical presence nexus threshold for BATs could create the analogous incentive for economically sub-optimal location decisions.

- *Artificial competitive advantage for the most aggressive tax-avoiders.* Enactment of BATSA would result in significant differences among corporations in the effective rate at which their profits are taxed — tilting the playing field to the competitive advantage of some corporations and the disadvantage of others. BATSA would reward with the lowest state corporate tax liability those corporations willing to implement the most aggressive corporate restructuring and tax-avoidance strategies — such as the intangible holding company tax shelter discussed above. Large corporations with multistate operations would have much greater expertise, resources, and opportunities to implement these strategies than would small, family-owned corporations serving a local market.

- *Example.* A multistate bookstore chain places computer kiosks in all its stores. The kiosks are linked to its World Wide Web operation. Store employees help customers place orders for books not available in the store at the kiosks. The stores advertise the address of the Web site in all their advertising. The stores even accept returns of unwanted books purchased at the Web site. Despite this critical sales assistance provided by the stores to the online operation, under BATSA the Web operation could easily avoid having to pay tax on its profit to any state(s) except the one(s) where it has offices, warehouses, or similar facilities.[16] The owner of a local independent bookstore, on the other hand, lacking the resources to set up an out-of-state electronic commerce Web site and distribution facility, would have 100 percent of his profit subject to taxation by the state in which the store is located.

A "Physical Presence" Nexus Standard Out of Sync with a 21st Century Economy

We live at a time when the combination of the Internet, inexpensive interstate transportation, and widely available consumer credit often enables even the smallest of businesses to tap into the market of distant states far more successfully, efficiently, and profitably than a horde of traveling salespeople could hope to do. Because of the vast expansion of interstate sales that has been sparked by the recent development of "electronic commerce," there seems to be a growing realization that the "physical presence" nexus threshold for the imposition of state *sales* taxes established by the U.S. Supreme Court's 1992 *Quill* decision makes little sense. Indeed, many trade associations supporting BATSA are on record supporting federal legislation reversing the *Quill* decision.[17]

Thus, it is inconsistent for the supporters of BATSA now to propose permanently enshrining substantial in-state "physical presence" as the threshold for the imposition of state business activity taxes. And it is incorrect for them to characterize this as a "modernization" of P.L. 86-272. Given the numerous organizational strategies and technologies corporations can now employ to make substantial sales and earn substantial profits in a state without actually being physically present within its borders, it is clear that a physical presence nexus threshold is obsolete and unfair. Can it really be argued seriously that states should be barred from taxing the profits of a corporation like Pizza Hut because it chooses to franchise its ubiquitous restaurants rather than own them directly? That is the kind of step backward in tax policy that BATSA would implement.

BATSA: An Internally Inconsistent Nexus Policy Designed to Favor Large Multistate Corporations

Proponents of federal BAT nexus legislation have stated time and again that the fundamental principle underlying the bill is that corporations do not benefit from public services in states in which they do not have a physical presence and therefore should not be required to pay a BAT to such a state.[18] Even assuming for the sake of argument that this indefensible principle were valid, it is clear that the bill as actually drafted does not reflect it — nor any other rational balancing of benefits received by businesses from public services and the businesses' obligation to support those services through the payment of taxes.

A principle that says that businesses should not be subject to tax in a state in which they lack a physical presence because they obtain no benefits from government services cannot be squared with a bill that allows corporations to have massive — indeed unlimited — amounts of several types of employees, property, representatives, and agents present within a state without establishing BAT nexus. Nor can the principle be squared with a bill that bars a state from imposing an income tax on a corporation that has 100 people in the state for 14 days in a particular year but allows the state to tax a business that has only a single employee in the state for 15 days. Clearly, the former business is likely to be benefiting more from state-provided services than is the latter.

Contrary to the claim of its proponents, what is on display in BATSA is not implementation of the principle that no physical presence equals no benefits from public services equals no obligation to pay taxes to support those services. Rather, BATSA is simply a "grab bag" of nexus "safe harbors" that the corporations lobbying for it would benefit from and think they may have sufficient clout to get through Congress. It is easy to discern the motives of many corporations that have publicly supported BATSA in the past — and presumably still do.[19] For example:

- Walt Disney/ABC, CBS, Discovery, and Time Warner would benefit from the expansion of P.L. 86-272 to encompass service businesses, since this would insure that in-state solicitation of advertising contracts from major corporations would not establish BAT nexus for these companies' television networks. They would also benefit from the safe harbor permitting employees to be present in a state gathering news and covering events without establishing nexus.

- A corporation like General Electric would likely benefit from a new safe harbor from nexus for any activities conducted in a state for up to 14 days by its employees or for an unlimited amount of time by one of its own subsidiaries.[20] Presumably many G.E. products, such as medical imaging equipment, are complex and often require on-site installation or trouble-shooting assistance from G.E. employees — a post-sale activity not currently protected by P.L. 86-272.

- BATSA would benefit corporations like The Limited, Talbot's, and The Gap, which have been sued by multiple states claiming that their trademark holding companies had nexus in those states. As explained above, BATSA would put an end to such litigation in the future and hinder state efforts to shut down this tax shelter.

- A company like UPS, which operates warehouses in which independent companies like Internet retailers store their inventory for quick delivery to customers, would benefit from a new safe harbor that provides that nexus is not created by the use of such third-party "fulfillment" services. Although the wording of BATSA is vague, this provision would be meaningless if it did not also encompass a nexus safe harbor for the storage of the retailer's inventory in the warehouse — which it presumably is intended to allow.

The pursuit of self-interest by these kinds of companies is not synonymous with a rational nexus threshold, however. A congressionally-imposed BAT nexus threshold even loosely based on the current text of BATSA would be a prescription for further litigation, inequity among businesses, and erosion of a vital source of funding for state and local services.

Rational and Fair Alternatives to BATSA Are Available

BATSA proponents have failed to make a convincing case for its enactment.[21] But if Congress nonetheless feels compelled to intervene in this area, workable and fair alternatives to BATSA are available. A proposed nexus standard developed by the Multistate Tax Commission, for example, would base the creation of nexus on relatively objective measures of the dollar amount of a business' sales occurring in a state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.[22] Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a BAT on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

A nexus threshold based on the volume of sales in a state can achieve this balancing of tax compliance costs and tax liability in a direct, administrable manner. Reasonable people can disagree about what the threshold should be. If business and state and local government representatives are unable to agree, Congress can be the final arbiter — just as Congress would be in proposed legislation establishing a sales-based nexus threshold for sales taxation. The "Main Street Fairness Act" introduced in previous congresses would have empowered any state adopting a prescribed set of measures aimed at simplifying its sales tax to require a non-physically present retailer to collect the state's sales tax if the seller had more than $5 million in nationwide sales.

Qualitative nexus thresholds that look to the type of activities occurring in the state and/or the relationships between in-state and out-of-state entities inherently create irrational and conflict-ridden tax policy. Public Law 86-272 itself demonstrates this. A corporation earning millions of dollars of profit in a state in which scores of its employees are continuously soliciting sales and dozens of its vehicles are continuously plying the roads loaded with millions of dollars worth of goods does not have income tax nexus under P.L. 86-272. At the same time, a small out-of-state retailer who sends employees into the state just twice each month to assemble a swing-set in someone's back yard for a few hundred dollars in profit *can* be required to pay an income tax to the state. Such disparate results cannot possibly be characterized as "rational and fair taxation."[23]

If Congress is determined to act in this area, a better approach would be to repeal P.L. 86-272 and substitute a nexus threshold based entirely on objective, quantitative measures of in-state business presence and activities. The $5 million sales threshold in the earlier versions of the Main Street Fairness Act or the Multistate Tax Commission's "factor presence" nexus standard (which looks to the dollar amount of property, payroll, or sales located in a state) would be good starting points for congressional consideration.

Notes

[1] See: Multistate Tax Commission, "Factor Presence Nexus Standard for Business Activity Taxes," October 17, 2002. Available at www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

[2] Corporate income taxes are levied by 44 states, the District of Columbia, and New York City. In 2008 these taxes supplied almost $58 billion to state and local treasuries.

[3] "This bipartisan legislation will provide a 'bright line' test to clarify state and local authority to collect business activity taxes from out-of-state entities. . . Specifically, the legislation establishes a 'physical presence' test such that an out-of-state company must have a physical presence in a state before the state can impose corporate net income taxes and other types of business activity taxes." Statement of Representative Bob Goodlatte, Congressional Record, April 8, 2011, p. E674.

[4] Like approximately twenty states, Maryland taxes the profits of multistate manufacturers only in proportion to their sales to Maryland customers. Accordingly, a Maryland-based manufacturer with no customers in Maryland would pay no corporate income tax to the state. Moreover, like roughly half the states, Maryland has not enacted a "throwback rule" to subject to taxation the profits earned by a Maryland manufacturer in other states in which the manufacturer has not established nexus. As a result of the combination of these two corporate income tax "apportionment" policies, the lion's share of the nationwide profit of a Maryland manufacturer that was protected from taxation in other states by BATSA would be "nowhere income" — profit that would not be taxed by any state. The interaction between BATSA and rules like those of Maryland that base corporate income tax liability on in-state sales alone are discussed in a separate Center report. See: Michael Mazerov, *Federal "Business Activity Tax Nexus" Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes,* Center on Budget and Policy Priorities, revised May 9, 2005.

[5] CBO Cost Estimate for H.R. 1956, July 11, 2006, available at www.cbo.gov/ftpdocs/73xx/doc7370/hr1956.pdf.

[6] Like approximately a dozen states, Massachusetts has enacted a special corporate income tax apportionment law for financial institutions that provides for the "throwback" of non-Massachusetts receipts to Massachusetts when a bank headquartered in the state is not taxable in the state in which its customers are located. See Chapter 63 of the Massachusetts statutes.

[7] An article written a number of years ago by an investigative reporter revealed just how little economic substance many of these "Delaware Holding Companies" have:

> "For a glimpse into this quiet and lucrative world, head up to the 13th floor of 1105 N. Market St.. Through smoked-glass windows, a visitor can view the high-rise headquarters surrounding Wilmington's prestigious Rodney Square: DuPont and Hercules, Wilmington Trust and MBNA. But turn back, and look inside this slender office tower. Tucked within the building's stark, upper floors, is another, hidden corporate center. Here, more than 700 corporate headquarters make up a vast and quiet business district of their own. The lobby computer lists their names: Shell and Seagram and Sumitomo, Colgate-Palmolive and Columbia Hospitals and Comcast, British Airways and Ikea, Pepsico and Nabisco, General Electric and the Hard Rock Cafe. How do 700 corporate headquarters squeeze into five narrow floors? How do 500 fit on the 13th floor alone? "Frankly, it's none of your business," said Sonja Allen, part of the staff that runs this corporate center for Wilmington Trust Corp. . . ." "Some of my clients are saving over $1 million a month, and all they've done is bought the Delaware address," said Nancy Descano, holding company chief of CSC Networks outside Wilmington."

Joseph N. DiStefano, "In the War Between the States, Delaware is Stealing the Spoils," Gannett News Service, January 25, 1996.

[8] John C. Healy and Michael S. Schadewald, 2011 *Multistate Corporate Tax Guide*, "Activities Creating Franchise or Income Tax Nexus (Part 1)," CCH (CD-ROM).

[9] The Maryland case upheld the state's authority to require the intangible holding company of the Syms clothing chain to pay Maryland corporate income tax on the royalties it earned by licensing use of the Syms trademark to Maryland Syms stores. The analogous cases in the other states named involved Kmart, The Limited, The Gap, and Toys R Us. In addition, the West Virginia Supreme Court upheld the authority of that state to impose its corporate income tax on an out-of-state bank issuing credit cards by mail to state residents.

[10] Bills to implement one major anti-IHC mechanism, "combined reporting," were introduced since 2000 in 22 states: Alabama, Arkansas, Connecticut, Florida, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Missouri, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, Virginia, West Virginia and Wisconsin. They were enacted in 7 of the 22: Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin. Bills denying an income tax deduction for royalty payments to IHCs have been introduced since 2000 in at least 15 states that have not enacted combined reporting: Alabama, Arkansas, Connecticut, Georgia, Indiana, Kentucky, Maryland, Mississippi, Missouri, New Jersey, North Carolina, Pennsylvania, Rhode Island, Tennessee, and Virginia. They were not enacted in three of them: Missouri, Pennsylvania, Tennessee. In most of the other 12 states the bills were so watered down with numerous exceptions after intense business lobbying that they arguably will be largely ineffectual against IHCs. (See: Charles F. Barnwell, Jr., "Addback: It's Payback Time," State Tax Notes, November 17, 2008.) In short, despite the serious fiscal problems of the states in the recent years, the business community has had a decent track record in blocking the two approaches to shutting down the IHC tax shelter that require state legislative action.

Moreover, H.R. 1439 adds to BATSA for the first time a new provision that will substantially undermine the ability of combined reporting to nullify IHCs. The new language will bar combined reporting states from assigning royalties received by IHCs to the states in which the trademark is used. This will result in a substantial revenue loss for many combined reporting states.

[11] Steven Maguire, *State Corporate Income Taxes: A Description and Analysis*, Congressional Research Service, updated June 23, 2008.?year?

[12] The holding in *Quill* reaffirmed the physical presence requirement for sales tax collection established by the Court's 1967 *National Bellas Hess* decision. Technically, the tax at issue in both cases was a use tax, not a sales tax. See: Michael Mazerov and Iris J. Lav, *A Federal "Moratorium" on Internet Commerce Taxes Would Erode State and Local Revenues and Shift Burdens to Lower-Income Households*, Center on Budget and Policy Priorities, May 1998, Appendix A. Available at www.cbpp.org/512webtax.pdf.

[13] The U.S. Supreme Court's stated goal in its 1992 *Quill* decision was to establish a "bright line" physical presence nexus threshold for state imposition of *sales* taxes. Surveying the widespread sales tax nexus litigation that had occurred in just the first few years subsequent to *Quill*, a leading expert on Internet tax-related issues stated flatly: "The current physical-presence standard for sales and use tax nexus has not created a bright-line test but instead has resulted in jurisdictional rules that are frequently ambiguous and inconsistent." (Karl Frieden, *Cybertaxation* (Arthur Anderson/CCH, Inc.), 2000, p. 356.) A leading law firm that litigates nexus cases for corporations concurred: "While . . . [*Quill*'s] 'bright line' [physical presence] rule was intended to bring clarity to the boundaries of legitimate state authority to impose an obligation to collect sales and use taxes, and to 'encourage settled expectations,' it has not produced the hoped-for certainty." (Troy M. Van Dongen, "Internet Retailers Under Fire: *Borders Online* Exemplifies the Predicament." Online newsletter of the Morrison & Foerster law firm, July 2002, available at www.mofo.com.). There have been numerous sales tax nexus cases in recent years. Amazon.com, for example, is currently embroiled in two high-profile sales tax nexus cases with New York and Texas.

[14] Statement of Elizabeth Harchenko before the Senate Committee on Commerce, Science, and Transportation, March 14, 2001.

[15] In a 1996 interview in *Fast Company* magazine, Bezos was asked: "You moved from New York to Seattle to start this business. Why?" He replied:

> It sounds counterintuitive, but physical location is very important for the success of a virtual business. We could have started Amazon.com anywhere. We chose Seattle because it met a rigorous set of criteria. It had to be a place with lots of technical talent. It had to be near a place with large numbers of books. It had to be a nice place to live — great people won't work in places they don't want to live. Finally, it had to be in a small state. In the mail-order business, you have to charge sales tax to customers who live in any state where you have a business presence. It made no sense for us to be in California or New York.
>
> Obviously Seattle has a great programming culture. And it's close to Roseburg, Oregon, which has one of the biggest book warehouses in the world. We thought about the Bay Area, which is the single best source for technical talent. But it didn't pass the small-state test. I even investigated whether we could set up Amazon.com on an Indian reservation near San Francisco. This way we could have access to talent without all the tax consequences. Unfortunately, the government thought of that first.

William C. Taylor, "Who's Writing the Book on Web Business," *Fast Company*, October/November 1996.

[16] BATSA provides that "using the services of an agent (excluding an employee)" in a state on more than 14 days "to establish or maintain the market in the State" creates nexus for the out-of-state business using the in-state agent, but only if "such agent does not perform business services in the State for any other person during such taxable year." There is nothing in the legislation that requires the "other person" to be an independent third party. The Web-based bookselling operation could easily bring itself under this safe harbor by incorporating two nominally-distinct subsidiaries, for example, one selling books and the other selling all other types of merchandise (greeting cards and calendars, for example). Because the store personnel (who are not employees of the Web site) would be helping "to establish or maintain the market" for two "other persons" — the subsidiary that sells books and the subsidiary selling other items — nexus would not be created for the Web operation by the activity of the stores' employees. As long as customers of the Web operation are nominally buying books and other goods from two different companies, the Web operation can avoid creating nexus in the states where the retail stores are located. The two Web stores could easily contract to share the same Web site and warehouses; no change in physical operations would be necessary.

[17] For example, the Council on State Taxation and the National Retail Federation are active supporters of proposed federal legislation reversing *Quill*.

[18] "The underlying principle of this legislation is that states and localities that provide meaningful benefits and protections to a business, like education, roads, fire and police protection, water, sewers, etc., should be the ones who receive the benefit of that business' taxes, rather than a remote state that provides no services to the business. By imposing a physical presence standard for business activity taxes, H.R. 1956 ensures that the economic burden of state tax impositions are appropriately borne only by those businesses that receive such benefits and protection from the taxing state." Written testimony of Arthur R. Rosen in support of H.R. 1956, Subcommittee on Commercial and Administrative Law, House Judiciary Committee, September 27, 2005. H.R. 1956 was the version of BATSA introduced in the 109th Congress.

[19] The most recent list of BATSA supporters appears to be the signatories of a letter in support of the legislation dated June 12, 2008 to former House Judiciary Chairman John Conyers and former subcommittee chair Linda Sanchez. All of the corporations listed in the following bullets were signatories.

[20] Recall again that a corporation can use a subsidiary to conduct activities on its behalf in another state for an unlimited number of days in a year without thereby establishing nexus so long as the subsidiary works for at least one other subsidiary. See Note 17.

[21] See: Michael Mazerov, "Proponents' Case for a Federally-Imposed Business Activity Tax Nexus Threshold Has Little Merit," Center on Budget and Policy Priorities, June 26, 2008; http://www.cbpp.org/files/6-26-08sfp.pdf.

[22] See the source cited in Note 1.

[23] A business coalition lobbying in support of previous versions of BATSA was known as the "Coalition for Rational and Fair Taxation." See www.batsa.org.

APPENDIX

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PROPOSED "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION WOULD SERIOUSLY UNDERMINE STATE TAXES ON CORPORATE PROFITS AND HARM THE ECONOMY

By Michael Mazerov

Appendix: What Kind of Tax-Avoidance Opportunities Would BATSA Open Up?

In lobbying for BATSA's enactment, organizations representing major multistate corporations claim their goal is to invalidate state laws that impose a business activity tax (BAT) on a business with no "physical presence" in the state. This claim, however, is highly misleading. BATSA would also create numerous nexus "safe harbors" — types of *clear and substantial physical presence* a business could have in a state without having to pay a BAT.

Expanding an Existing Federal Limit on State Taxing Authority

Several of the new nexus safe harbors take the form of an expansion of an existing federal law, Public Law 86-272. Enacted in 1959, it was intended to be a temporary moratorium on states' ability to impose corporate profits taxes on certain out-of-state corporations, but it was never repealed.[1] P.L. 86-272 decrees that a state may not impose a corporate profits tax on an out-of-state corporation if the firm meets three conditions:

- its only activity within the state is soliciting orders for the sale of physical goods;
- it approves the orders at an out-of-state office; and
- it ships or delivers the goods into the purchaser's state from another state.

P.L. 86-272 clearly represents a nexus safe harbor: it allows corporations to have an *unlimited* number of salespeople in a state at *all times* yet remain exempt from income tax if the salespeople work out of home offices or visit from out of state.[2] In the law's absence, the regular presence of a salesperson in a state would obligate the corporation to pay some income tax to that state (assuming the corporation was profitable). The law also permits companies to provide their sales forces with company-owned cars, product samples, computers, furniture, and similar equipment yet remain exempt from income tax in the states where the salespeople solicit business.[3] Finally, P.L. 86-272 permits companies to have an unlimited number of their own trucks continuously plying the roads of a state loaded with an unlimited amount of goods en route to customers there without being liable for any corporate tax payment.

BATSA would expand the coverage of P.L. 86-272 in three significant ways.

Including Sales of Services and Intangible Property

First, BATSA would extend P.L. 86-272 — which deals only with the sale of physical goods — to include sales of services and intangible property. If BATSA were enacted, for example:

- A Delaware bank could send an unlimited number of loan officers into Maryland to encourage businesses to borrow from the bank, without having to pay Maryland tax on the profits it earns from its Maryland borrowers.[4]

- A New York-based television network could send an unlimited number of advertising salespeople to visit major corporations headquartered in other states to solicit the purchase of air time, without having to pay taxes in those states.

- A franchisor like Pizza Hut could enter a state an unlimited number of times to solicit sales of its franchises (a form of intangible property) to potential franchisees — for example, by renting a meeting room in a hotel to conduct a sales meeting — without owing any tax in the state.

Including Activities Besides Solicitation of Orders

Second, while P.L. 86-272 deals only with the solicitation of orders, BATSA would extend the law to cover four new activities:

- "furnishing of information to customers or affiliates in [the] state";

- "coverage of events," if the information gathered is "used or disseminated from a point outside the state";

- "gathering of information," if the information gathered is "used or disseminated from a point outside the state"; and

- "business activities directly related to . . . [the] potential or actual purchase of goods or services within the state if the final decision to purchase is made outside the state."

A company could conduct these activities for an unlimited number of days each year with an unlimited number of employees — and could furnish them with any equipment necessary to carry out these activities — without establishing nexus, provided they worked out of their homes. For example:

- A local TV station could permanently base reporters in a neighboring state within its media market so long as the footage was relayed to the home-state broadcasting facility for transmission to viewers. The station could furnish the reporters with a mobile broadcasting van and video cameras so long as the equipment was stored in a garage at one of the reporters' homes.

- A fast-food franchisor could send an unlimited number of employees to its franchisees' restaurants for an unlimited number of days to inspect compliance with company standards.[5]

- A bank could permanently base employees in a state to investigate the credit-worthiness of potential borrowers.[6]

- A corporation could permanently base an unlimited number of employees in a state to recruit new employees or purchase supplies or equipment for their employer.

In each of these examples, the firm would be exempt from the state's business activity taxes despite the police and fire protection, roads and other infrastructure, and other services provided to company employees and property.

Extending P.L. 86-272 to Include Other Business Activity Taxes

Third, BATSA would extend the protections of P.L. 86-272 (including the four new activities) to taxes other than corporate income taxes. Such taxes would include the following, most of which substitute for a state corporate income tax:

- the Washington (state) Business and Occupations Tax, the Ohio Commercial Activities Tax, and the Delaware Merchants' and Manufacturers' License Tax (all of which are broad-based taxes on business gross receipts),

- the New Hampshire Business Enterprise Tax (a form of value-added tax), and

- the Texas Franchise Tax and Michigan Business Tax (modified gross-receipts taxes that allow deductions from gross receipts for certain business expenses).

The adverse impact of BATSA on the revenues of these states would be much larger than in other states because they are not now subject to P.L. 86-272 and therefore *are* currently imposing these taxes on the many corporations that have salespeople within their borders soliciting orders of goods.

The 14-Day Physical Presence Safe Harbor

In order to interact with their customers and produce goods and services, many kinds of businesses need to send employees and equipment into states in which they do not actually maintain offices, factories, or other permanent facilities. For example, an equipment manufacturer may visit its customers to install and troubleshoot its products, a construction company may send heavy equipment to a building site, and advertising agency personnel may meet at a client's office to plan a campaign.

Under current law, these kinds of activities would almost certainly obligate a company to pay the state's corporate income tax or other BAT, if the state chose to impose it.[7] Under BATSA, however, companies in the above examples could arrange their affairs to avoid income tax liability to any state in which they did not maintain a permanent, "brick-and-mortar" facility. This is because BATSA would permit a company to place any amount of property and any number of employees in a state to conduct any activity it wishes, without creating nexus, as long as the property or equipment remains in the state for 14 or fewer days per tax year.

Moreover, this provision effectively would allow many corporations to keep an unlimited amount of equipment and employees in a state for far *longer* than 14 days without creating nexus. This is because the 14-day limit applies to each individual corporation as a legal entity, including corporations that are subsidiaries of other corporations. For example:

- A movie studio that needed to shoot three different movies on location in a particular state for 14 days each in a given year could incorporate each of the three productions separately. When the movies were completed, the subsidiaries would be liquidated.

- A company that needed to have employees in a state for more than 14 days per year in order to repair customers' computers could avoid establishing nexus outside its home state by incorporating a number of subsidiaries to employ its repair personnel and assign repair tasks to particular subsidiaries on a rotating basis to keep all of them below the 14-day limit.

There is nothing far-fetched about these scenarios. Corporations already go to great lengths to shelter their profits from state taxation by forming new subsidiaries:

- Hundreds (if not thousands) of corporations have incurred significant accounting and legal expenses to incorporate and operate "intangible holding company" subsidiaries. The North Carolina *Limited* case cited in the body of this report revealed that The Limited established nine separate Delaware subsidiaries to hold title to the trademarks of the various retail chains it owned.[8]

- Over 1,300 corporations, including Dell Computer and former "Baby Bell" company SBC Communications, created new limited partnership subsidiaries to take advantage of a self-imposed nexus limitation on out-of-state corporate partners Texas enacted in the early 1990s.[9]

- A number of states and the U.S. Government Accountability Office have documented a widespread corporate practice of "SUTA [State Unemployment Tax Act] dumping." In its most common form, corporations create new subsidiaries and transfer their employees to them to take advantage of lower unemployment tax rates for which new corporations typically are eligible. GAO documented that this strategy was widely marketed by certain accounting and consulting firms, which apparently saw it as a legal way to minimize their state unemployment taxes.[10] Congress recognized SUTA dumping as an abusive tax shelter and enacted legislation in 2004 that bans it.[11] Businesses quickly found ways around the ban, however, and SUTA dumping remains a problem.[12]

- Well-known Internet retailer Amazon.com has separately incorporated its distribution warehouses in order to avoid establishing sales tax nexus in the states in which they are located.[13]

In short, BATSA's 14-day safe harbor would allow many sophisticated multistate corporations to avoid having a business activity tax liability in many or all states in which they have customers. Firms could maintain substantial numbers of employees and substantial amounts of equipment in a state on a continuously rotating basis without creating BAT nexus.

This ability belies proponents' fundamental rationale for BATSA: that "only states and localities that provide meaningful benefits and protections to a business. . . should be the ones who receive the benefit of that business' taxes."[14] Clearly, a corporation that maintains personnel and property in a state for extended periods of time is receiving benefits and protections from that state — whether or not it maintains a permanent "brick and mortar" facility there.

Safe Harbor for Hiring Firms to Do In-State Work

In its 1960 *Scripto* decision, the U.S. Supreme Court ruled that allowing a corporation to avoid nexus in a state by hiring an independent in-state business to solicit business there, rather than using its own employees, would "open the gates to a stampede of tax avoidance." In its 1987 *Tyler Pipe* decision, the Court held that a state had the right to impose a business activity tax on an out-of-state corporation that had contracted with an independent contractor to conduct activities that were "significantly associated with the [out-of-state corporate] taxpayer's ability to establish and maintain a market in [the] state for [its] sales."

When, under the authority of these decisions, states impose a tax on an out-of-state corporation based on in-state activities that another business conducts on its behalf, this is often referred to as "attributional nexus." If states did *not* have this authority, corporations would have virtual free rein to avoid nexus in every state except the one in which they are headquartered. This is because a corporation can contract with an individual, an unrelated business, or one of its own subsidiaries to carry out almost any business function rather than have its own employees perform it.

In three different ways, BATSA would make it significantly harder for states to assert attributional nexus. The likely result, as the Supreme Court has predicted, would be massive corporate tax avoidance — above and beyond that resulting from the bill's other provisions.

The "Two Clients Loophole"

The most far-reaching of these provisions — and the one likely to do the most damage to state and local BAT revenues — decrees that a state may not subject an out-of-state corporation to a BAT on the basis of activities another business conducts on its behalf so long as the in-state business performs services on behalf of at least one additional client during the tax year. The provision, which applies to activities designed to "establish or maintain the market in the State" for sales by the out-of-state company, is effectively aimed at reversing the *Tyler Pipe* decision discussed above.[15]

This provision's enormous potential for harm arises from the fact that it applies even if all of the parties are related. A corporation can form two out-of-state subsidiaries that then "hire" a third subsidiary to conduct activity on their behalf in the state in which they wish to avoid nexus. For example:

- To maximize its ability to make sales throughout the United States, a Texas-based manufacturer of personal and network server computers needs to provide on-site repairs and set up local area networks for customers. Ordinarily, these tasks would establish BAT nexus for the firm, even if it hired another firm (or one of its subsidiaries) to perform them, since they help establish and maintain the company's market in that state. The corporation, however, wants to avoid establishing BAT nexus outside of Texas, a state that neither taxes corporate profits nor levies its franchise tax on services delivered outside the state. If the corporation can avoid establishing nexus outside of its home state, none of the profits it earns on non-Texas sales of its computers will be taxable *anywhere.*

  Under BATSA, this would be easy to accomplish. The corporation would simply reorganize itself into three legal entities: one to provide the on-site repair and networking services, one to sell desktop computers, and one to sell server computers. Since the repair/networking subsidiary provides these services to more than one business (that is, to both the subsidiary that sells desktop computers and the subsidiary that sells servers), under BATSA those services no longer would create BAT nexus outside of Texas for the computer manufacturer. The states in which the customers are located could tax any profits earned by the repair/networking subsidiary but not the profits earned on the actual sale of the computers.

- Most major retail chain stores have transformed themselves into "bricks and clicks" businesses by setting up subsidiaries to sell the same merchandise over the Internet that they sell in stores. These businesses are looking for ways to integrate their operations so that the stores facilitate greater purchases from the website, such as selling gift cards in stores that can be redeemed online and allowing in-store pickup of items purchased online. Under the *Tyler Pipe* decision, such activities create BAT nexus for the web subsidiary because they help the subsidiary establish and maintain a market in the state(s) where the stores are located.

  Under BATSA, however, the retail chain could split its web operation into two separate corporations and have each one sell a portion of the company's product lines. Under such a structure, the stores' activities would help establish and maintain the market in the state for more than one business (i.e., the two web subsidiaries), thereby bringing themselves under this nexus safe harbor in BATSA. The web subsidiaries, meanwhile, could contract with each other to share a common website, warehouses, and other operational requirements, so the corporation's out-of-pocket costs would not be substantial.

Of course, this provision of BATSA also would enable out-of-state corporations to use *independent* in-state corporations to help them establish and maintain a market within a particular state without creating BAT nexus:

- In some states, consumers can purchase electricity from independent power producers (sometimes located out of state) that own their own generating plants but contract with local utility companies to deliver electricity into customers' homes, read customers' meters, and bill customers. The activities performed by the local utility create nexus in the state for the out-of-state power generator because they are critical to its ability to establish and maintain a market in the state. Under BATSA, however, the power generators would no longer have BAT nexus in their customers' state(s) because local utilities typically deliver power for several independent generators. Even if a utility delivered power for only a single independent generator, the latter could easily avoid nexus by dividing itself into two legal entities, for example, one to sell power to businesses and one to sell power to residential customers.

In sum, by effectively overruling the *Tyler Pipe* decision, BATSA would open enormous opportunities for corporations to shelter substantial shares of their profits from taxation by the states in which their customers are located.

Agents Not Involved in Selling Don't Establish Nexus

BATSA would also change current law by declaring that contracting with another company to conduct activities *not* related to selling or interacting with customers would *never* create nexus. Under current law, it is not entirely clear when non-customer-related activities performed by another party would create BAT nexus. Most experts likely would agree, however, that if the contract made the second party the actual legal agent of the company contracting for its services, such a contract would create nexus.

For example, imagine that a California manufacturer hires an unrelated Oregon business to continuously perform quality control checks on its behalf at an Oregon plant run by a third company that assembles a key component of the California manufacturer's products. The Oregon quality-control business has the authority to sign off that the components meet the California manufacturer's specifications and to stop shipment of the products if they do not. Under this scenario, the presence of the quality-control business in Oregon would likely be sufficient to create BAT nexus there for the California manufacturer.

Under BATSA, however, the California manufacturer would avoid nexus in Oregon because the activities conducted by the quality-control subcontractor do not involve "establishing and maintaining the market" for *sales* by the *manufacturer*. In short, any purchasing-related activities (as opposed to selling-related activities) conducted in a state by a third party would no longer be nexus-creating under BATSA — even where the very same activities would be nexus-creating if the corporation's own employees conducted them.[16]

In-State Presence of Agents Also Qualifies for the 14-Day Safe Harbor

Finally, BATSA allows an in-state business to conduct any activity on behalf of an out-of-state corporation in a state for 14 days per year without creating BAT nexus for the latter. This provision is consistent with the BATSA provision allowing a company to have its *own* employees and property in a state for up to 14 days for any purpose without creating nexus. Nevertheless, it also inherently creates a new nexus safe harbor.

New Safe Harbor for In-State Storage of Inventory

P.L. 86-272 contains the following provision:

> [A] person shall not be considered to have engaged in business activities within a State . . . by reason of the maintenance of an office in such State by one or more independent

contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

This provision appears primarily intended to ensure that no state could assert attributional nexus over an out-of-state manufacturer based on its having engaged the services of an independent "manufacturers' rep" firm to solicit sales on its behalf. (This is a common mechanism by which manufacturers solicit business throughout the country.[17]) The nexus protection applies even if the manufacturers' rep firm maintains an actual physical office within the state.

BATSA would expand this safe harbor, allowing an independent contractor to use an in-state office for the purpose of "fulfilling transactions" on behalf of an out-of-state corporation without establishing nexus for the latter.

Manufacturers, Internet retailers, and other sellers of goods commonly store inventories of finished products at "fulfillment" or "logistics" warehouses operated by independent companies. The warehouses ship the products to the sellers' customers on demand. Under current law, this activity unquestionably establishes BAT nexus for the sellers in a state in which a warehouse is located because the sellers continue to own the inventory and thus have a "physical presence" there.

BATSA, however, states that the use of a third-party "office" to "fulfill transactions" would *not* establish nexus, and this strongly implies that inventory storage at a third party fulfillment warehouse would not establish nexus either. As noted above, BATSA's attributional nexus language would *already* bar a state from asserting nexus over an out-of-state manufacturer that hired an in-state agent to fulfill orders if the agent did so on behalf of at least two separate businesses. Third-party-operated warehouses virtually always have multiple customers. Thus, if the language were not intended to provide nexus protection for the actual storage of the inventory, it would not be needed.

At least one highly-credentialed state tax practitioner has interpreted this provision as "Expanding P.L. 86-272 [to] exempt . . . *storage of inventory* with an independent contractor."[18] This provision may also explain, in part, why UPS, which has a fulfillment arm, supports BATSA.[19]

In sum, it appears that this BATSA provision is designed to allow an out-of-state corporation to store an unlimited amount of inventory for delivery to its customers at a third-party-operated warehouse without thereby establishing BAT nexus in the state where the warehouse is located.

The "Limited or Transient Business Activity" Safe Harbor

Finally, BATSA states that a corporation's physical "presence in State to conduct limited or transient business activity" does not create BAT nexus. Since BATSA does not define "limited" or "transient," it is impossible to know what activities the sponsors intend this safe harbor to cover.

One legal analyst fears that this provision could become a "black hole," swallowing state and local BAT revenues.[20] He points out that the dictionary definitions of these terms would provide strong grounds for exempting from business activity taxes any corporation that either enters a state on a temporary basis or that does not engage in the state in the full set of activities comprising its business:

> With the terms "limited" and "transient" neither defined in the bill nor possessed of any accepted meanings in tax law, courts would look to dictionary definitions for their meaning. "Limited" is defined in *Black's Law Dictionary* as "restricted; bounded; prescribed. Confined within positive bounds; restricted in duration, extent, or scope." "Transient" is defined in *Black's* as "Passing across, as from one thing or person to another; passing with time of short duration; not permanent; not lasting."
>
> . . . [A] company's activity could be permanent but limited in scope, or unlimited in scope but not permanent, and still be protected from taxation. . . . For example, a corporation whose charter or application to conduct business in the state indicates that it will engage only in banking activities and nothing else (so that its activities are "limited," as "restricted in . . . scope") could be protected from taxation even if in the state permanently, as could a corporation whose charter or application indicates that it will engage in every activity in the state that a corporation may legally perform, but will do so only for 10 years (so that its activities are "transient," as "not permanent"). [21]

At the very least, since BATSA already contains a separate, across-the-board safe harbor for any level of activity conducted in a state for 14 days, it is logical to assume that this provision is intended to provide corporations with an opportunity to enter a state temporarily to engage in business activities for longer periods of time than that.

It is also easy to foresee this provision being used as a catch-all "insurance policy" against any adverse court interpretations of other vague provisions of the legislation. For example, a company storing inventory at a third-party fulfillment warehouse in a state would likely claim that such storage is a protected "limited" activity just in case a judge were inclined to interpret the vague "fulfilling transactions" language discussed in the previous section as *not* providing a safe harbor from nexus.

Enacting BATSA with this provision intact would spur both continuous litigation and divergent decisions in the state courts that would hear the cases. It is simply inconceivable that BATSA proponents can continue to describe the bill as establishing a "bright-line," nationally-uniform nexus standard after having included this safe harbor in recent versions of the legislation.

Conclusion

BATSA would stimulate a wave of new corporate tax sheltering activity by making it much harder for states and localities to tax out-of-state corporations that have a substantial physical presence within their borders and benefit from state and local services. By exploiting the numerous safe harbors outlined above, out-of-state corporations could avoid paying their fair share of taxes, significantly weakening state and local revenue systems.

Notes

[1] Like BATSA itself, P.L. 86-272 applies to all income taxes imposed on all types of businesses and individual "sole proprietors." For the sake of readability (and because BATSA's most significant revenue impact would be on corporate tax payments), this report generally refers to corporate income or profits taxes.

[2] A company-owned office, even if used just for solicitation of orders, is not protected by P.L. 86-272, so a state is free to impose a corporate income tax on an out-of-state corporation with such an office within its borders.

[3] Despite continuous litigation, more than 30 years elapsed after the enactment of P.L. 86-272 before the U.S. Supreme Court gave any guidance as to what activities were encompassed in the law's safe harbor for "solicitation" — the key term in the law that Congress nonetheless had not seen fit to define. In its 1992 decision in *Wrigley* v. *Wisconsin*, the Court made clear that activities "entirely ancillary to solicitation" (such as the presence of property used by salesmen) were also protected by P.L. 86-272.

[4] Arguably these loan officers also would be free to solicit *deposits* from the Maryland businesses, since another safe harbor in the bill states that the presence of employees to negotiate the purchase of goods and services for the business also does not establish nexus. Deposits could be characterized as intangible goods or services purchased by banks through the payment of interest.

[5] A franchisor would argue that inspecting franchisee compliance with a franchise agreement is a form of "gathering information" that would be "used" at its out-of-state headquarters to formulate remedial action. A franchisor would similarly argue that conducting on-state training of franchisee employees (another common activity) would not be nexus-creating because it satisfies BATSA's safe harbor for "furnishing of information to customers or affiliates in a state."

[6] A bank would argue that in-state investigation of the credit-worthiness of a borrower would be protected by BATSA's safe harbor for the "gathering of information."

[7] That would be true even of a seller of services newly covered by BATSA's expanded version of P.L. 86-272, since both performing services in a state and engaging in almost any kind of post-sales interaction with a customer are beyond P.L. 86-272's nexus safe harbor for "solicitation of orders."

[8] *Secretary of Revenue of North Carolina* v. *A&F Trademark, Inc.*, et al., North Carolina Tax Review Board, May 7, 2002.

[9] See: Robert T. Garrett, "Business Lobbyists Thwarting Efforts to Close Tax Loophole," *Dallas Morning News*, May 12, 2003. In a 2003 letter to members of the National Conference of State Legislatures, a business coalition supporting BATSA questioned the relevance of this Texas experience to BAT nexus legislation, since the legislation itself would not have prevented Texas from shutting down this tax shelter. To reiterate, Texas' experience demonstrates that if artificial restrictions on taxing jurisdiction are created by *either* federal or state legislation, corporations will go to great lengths to restructure their operations to take advantage of any tax sheltering opportunities thereby created. As documented in this Appendix, the enactment of BATSA would create numerous such opportunities. The Texas Franchise Tax law was substantially overhauled in 2006 to forestall the use of limited partnerships as a mechanism of tax avoidance.

[10] See: U.S. General Accounting Office, *Unemployment Insurance: Survey of State Administrators and Contacts with Companies Promoting Tax Avoidance Policies*, GAO-03-819T, June 19, 2003.

[11] See: H.R. 3463, the "SUTA Dumping Prevention Act of 2004," signed into law by President Bush on August 9, 2004.

[12] See: Gary Perilloux, "Program Nabs More Tax Cheats," *The Advocate* (Baton Rouge), June 19, 2007. See also: "Two Employers Settle SUTA Dumping," October 13, 2010 press release from the Michigan Unemployment Insurance Agency. The release notes: "The first case involves a Michigan employer in the construction industry. The employer set up a 'captive' leasing arrangement, forming its own employee-leasing companies from which it leased its employees."

[13] See: Amy Martinez, "Amazon.com Fights Sales Taxes after Getting Other Breaks," *Seattle* Times, January 24, 2011.

[14] Letter from Arthur R. Rosen to Representative Steve Cohen, Chairman, Subcommittee on Commercial and Administrative Law, House Judiciary Committee, February 4, 2010, in connection with a hearing held that day on "State Taxation: The Role of Congress in Defining Nexus."

[15] In *Tyler Pipe*, the Court held that hiring an independent representative in a state to solicit sales and conduct other activities that helped an out-of-state corporation create and maintain a market for its products was no different from having an employee in a state engaged in the same activities and did indeed establish BAT nexus for the out-of-state

corporation. There was no suggestion whatsoever in the case that the holding would have been any different if the in-state representative had solicited sales on behalf of more than one out-of-state company; in fact, the evidence strongly suggests that it did. The *Tyler Pipe* decision of the Washington State Supreme Court, which the U.S. Supreme Court reviewed, states that the Washington representative of Tyler Pipe was Ashe and Jones, Inc. of Seattle. Ashe and Jones was characterized by Tyler Pipe as an independent contractor, suggesting that it solicited Washington sales on behalf of multiple out-of-state businesses. Ashe and Jones appears to have been at that time a typical "manufacturers' representative" firm with multiple clients. The company certainly has multiple clients today, including Tyler Pipe. See: www.alliancesalesnw.com/alliancesalesnw_002.htm.

[16] This scenario would not necessarily fall into the previously discussed safe harbor for "activities directly related to. . . [the] potential or actual purchase of goods or services" because it involves quality control on goods that arguably have already been purchased.

[17] See the website of the Manufacturers' Agents National Association at www.manaonline.org.

[18] Deborah K. Rood, "State and Local Tax Issues," undated Powerpoint presentation; available at http://conferences.aicpa.org/materials/downloads/State_Local_Issues-Deborah_K_Rood.pdf (emphasis added). Rood is a former member of the State and Local Tax Technical Resources Panel of the Tax Division of the American Institute of Certified Public Accountants.

[19] See: letter in support of BATSA dated June 12, 2008 to former House Judiciary Chairman John Conyers and former subcommittee chair Linda Sanchez.

In the past, the trade association representing the third-party warehouse industry has not been satisfied with the language under discussion here and has sought broader and more explicit nexus protection in BATSA for corporations that store goods in their warehouses. (See: www.iwla.com.) This is not surprising, since some corporations also store materials in third-party warehouses that are *not* shipped directly to customers (for example, materials requiring further processing), and language restricted to "fulfillment of transactions" likely would not protect such corporations from nexus. However, the industry's desire to obtain a blanket nexus exemption for storage of any type of goods in a third-party warehouse in no way obviates the value to many companies of BATSA's existing language on this issue.

[20] Matt Tomalis, "Some Fatal Flaws of S. 1726, H.R. 5267, and All BAT Nexus Bills," *State Tax Notes*, March 3, 2008, pp. 691-704. At the time he wrote this, Tomalis was a staff attorney with the Federation of Tax Administrators.

[21] Tomalis, p. 695.

May 4, 2011

The Honorable Howard Coble
Chairman
Subcommittee on Commercial and Administrative Law,
House Judiciary Committee
U.S. House of Representatives

The Honorable Steve Cohen
Ranking Member
Subcommittee on Commercial and Administrative Law,
House Judiciary Committee
U.S. House of Representatives

Dear Rep. Coble and Rep. Cohen:

I write on behalf of Citizens for Tax Justice to urge the House Judiciary Committee to reject the so-called "Business Activity Tax Simplification Act" (BATSA), H.R. 1439.

This legislation would make state and local taxes on businesses dramatically more complex, increase litigation related to business taxes, increase government interference in the market and reduce revenue to state and local governments by billions of dollars each year.

No member of Congress would openly claim to support any of these outcomes. But the corporate lobbyists promoting BATSA have disguised their true goals with a deceptive argument. They claim that simplification will result from enacting a federal law limiting state and local governments to taxing only those businesses that have a "physical" presence in the state.

Increased Complexity
Even if the "physical presence" standard made any sense, it would not matter under H.R. 1439 because it is not the standard set out in the bill. The bill has many "safe harbors" which are essentially loopholes allowing large corporations with lobbying clout to avoid state and local taxes even though they have what any rational person would call a "physical presence" in the jurisdiction.

Under BATSA, a company that sends a full-time worker into another state each day to install equipment could be subject to that state's taxes. However, if the company created two subsidiaries which each provided half of the equipment and which each hired the worker to perform the installations, the state would not be able to tax the business under BATSA.

The state would also be unable to tax a business if the employee was only sent into the state 14 days each year, or if the company created several subsidiaries that each hired the employee and sent him or her into the state for just 14 days each year. Can anyone honestly call this simplification?

If the company warehoused items in the state before shipping them to customers, one would think this, at least, constitutes "physical presence," but under BATSA it might not. Items could be warehoused in the state by a second company that ships them to customers and this second company could also be exempt from the state's business activity taxes under the exception for third-party "fulfillment" activities.

Perhaps the most outrageous abuses would occur when a company is actually based in the state in question. Such a company might create subsidiaries in other states (states without business activity taxes) and transfer trademarks and logos to them. The company would then pay royalties to those subsidiaries for the use of the trademarks and logos, and these payments would reduce or even wipe out the income reported to the state where the company is based. Most states currently have laws that allow them to tax the out-of-state subsidiaries receiving royalties in this scenario, but BATSA would nullify those laws so that this type of tax avoidance would increase dramatically.

In other words, BATSA would greatly increase complexity and the incentives for companies to engage in aggressive tax planning to avoid state and local taxes.

Increased Litigation
The various intricacies of BATSA that would encourage more aggressive tax planning would naturally lead to increased litigation. Besides that, some of the safe harbors in BATSA are not defined at all, which will certainly leave state and local governments no choice but to call upon the courts to interpret the provisions of the law when companies manipulate them.

For example, even a company that has physical property and employees in a state will not have a "physical presence" there under BATSA if the property and employees are only used to carry out "limited and transient business activity," which is left undefined. It's difficult to imagine how this ambiguity could *not* lead to increased litigation.

Increased Government Interference in Economy
Perhaps some lawmakers may comfort themselves with the notion that despite all of these problems, in the end BATSA will mean the government has a lighter hand in the economy because businesses will be taxed by fewer state and local governments.

To the contrary, BATSA is the ultimate example of government picking "winners and losers" among businesses competing against each other. BATSA would create artificial advantages for very large, multi-state companies that conduct most of their business online or over the phone and which have the resources to engage in the type of tax avoidance schemes already described.

Even if BATSA was dramatically amended so that it imposed a true "physical presence" standard, it would still create an artificial advantage for large, multi-state companies and make it more difficult for independent, local businesses to compete.

In the internet age, when we all buy countless products and services from out-of-state companies, "physical presence" is not a reasonable standard to determine which companies should be taxed by a state or local government. Companies that ship products into a state benefit from the roads that facilitate delivery, the state and local courts that are used to enforce contracts, and the telephone and cable lines that are regulated by state agencies. An out-of-state company that receives all of these benefits should help pay to finance them. And yet, under BATSA, the responsibility of financing these benefits would be further concentrated on independent, local businesses.

Reduced State and Local Revenue

The Congressional Budget Office estimated in 2006 that a very similar bill would cost state and local governments collectively around $3 billion annually. The cost of the legislation currently under consideration would likely be even bigger because the bill provides more loopholes than previous versions.

The reasons for the projected revenue loss are straightforward. Companies would avoid taxes in the jurisdictions where they are actually conducting much of their business. Some states have laws that allow them to tax the income and activities of their businesses if they are not taxed by any other state, but many states do not have such laws. The phenomenon of "nowhere income," which is not taxable in any state, will become more prevalent and will benefit those corporations large enough to conduct business across state lines and to engage in the sort of tax avoidance schemes described here.

In short, BATSA has nothing to do with tax simplification or economic efficiency. Instead, it is still another example of large, multi-state corporations trying to shirk their tax responsibilities.

Sincerely,

Robert S. McIntyre
Director, Citizens for Tax Justice

MULTISTATE TAX COMMISSION
Working Together Since 1967 to Preserve Federalism and Tax Fairness

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April 11, 2011

The Honorable Howard Coble
Chairman
Subcommittee on Courts,
Commercial & Administrative Law
U.S. House of Representatives
Washington, DC 20515

The Honorable Steve Cohen
Ranking Member
Subcommittee on Courts,
Commercial & Administrative Law
U.S. House of Representatives
Washington, DC 20515

RE: H.R. 1439, *Business Activity Tax Simplification Act of 2011*

Dear Chairman Coble and Ranking Member Cohen:

This letter is regarding your Subcommittee's hearing on H.R. 1439, the *Business Activity Tax Simplification Act of 2011* (BATSA), scheduled for April 13, 2011. The Multistate Tax Commission opposes this legislation.

Background

The Multistate Tax Commission is an intergovernmental state tax agency created in 1967 by the states as an effort to protect state tax authority and work to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises.

BATSA Hurts Local Businesses

BATSA would authorize a wave of new corporate tax sheltering activity aimed at avoiding state and local business taxes. It would reward the major multistate corporations pressing for its enactment with eliminated tax liability in many states in which they are doing business. These large, multistate corporations would enjoy an unfair advantage compared to their small business competitors who are locally-oriented and who would become the bulk of the corporate tax base for a state.

With large, multistate corporations emboldened to eliminate their jobs and investment in a state (following the BATSA provisions), yet still being able to profit from a state's economic market, the resulting reduction in the business tax base leaves state legislatures with the unpleasant task of cobbling together needed revenue by increasing taxes on small businesses and individuals or cut important state services.

BATSA Hurts State Fiscal Positions

BATSA would cause a large majority of states to lose substantial corporate income tax payments (and other business activity tax payments as well) from multistate and multinational corporations that would no longer be subject to tax because of the higher nexus threshold that would be established by the bill.

The Congressional Budget Office has concluded that the enactment of substantially similar versions of BATSA would cause state and local governments to lose approximately $3 billion in annual revenues once corporations have an opportunity to restructure their operations to take full advantage of the tax-sheltering opportunities the bill creates. The National Governors Association placed that loss at $ 6.6 billion. Because H.R. 1439 goes beyond prior bills to also pre-empt state apportionment provisions, the impact would be even greater. Thus, BATSA represents a huge unfunded mandate; indeed, it would be the largest state tax preemption mandate since the Congressional Budget Office began to track them.

By depriving states of business activity tax revenues they currently are collecting, the legislation would impair their ability to provide services that are a critical foundation of a healthy national economy — such as high-quality K-12 and university education, public safety, and transportation infrastructure. Already, for Fiscal Year 2012 (which begins July 1, 2011 for most states), 44 states are projecting budget shortfalls. These same states have dealt with serious revenue gaps for the last three fiscal years. Projections show that states will be continue to be challenged with major shortfalls for a number of years. To close these gaps, hundreds of thousands of jobs will be in peril. This is not the time to consider legislation which will worsen this serious situation.

Conclusion

A congressionally-imposed business activity tax nexus threshold even loosely based on the current text of BATSA would foster inequity between big and small businesses, and thus create an unbalanced environment where giant multistate and multinational corporations could compete, without paying taxes, with local businesses.

In today's economic environment, any federal preemption of state tax authority must be taken very seriously and an act which so clearly benefits the richest corporations over our struggling small local businesses should be opposed. States agree there should be uniform rules for state tax nexus and have made progress toward this goal. There is no need for federal preemption of this critical state issue.

I attach a white paper from the National Governor's Association regarding an earlier version of this legislation which further explores the myriad issues with BATSA. Thank you for your consideration of our views.

Sincerely,

Joe Huddleston, LLD
Executive Director

Encl
as

CC: Members, Subcommittee on Courts, Commercial and Administrative Law

ATTACHMENT

IMPACT OF H.R. 1956, BUSINESS ACTIVITY TAX SIMPLIFICATION ACT OF 2005, ON STATES

September 26, 2005

Executive Summary

On April 28, 2005, H.R. 1956, the "Business Activity Tax Simplification Act of 2005" was introduced in Congress by Representatives Rick Boucher and Bob Goodlatte of Virginia. The bill would impose a federal physical presence standard for determining when a state can impose a business activity tax (BAT). In order to determine the impact of a bright-line nexus for state business activity taxes, the National Governors Association worked with the Federation of Tax Administrators (FTA) and the Multi-state Tax Commission (MTC) to survey state revenue agencies asking them to estimate the impact of such legislation on their respective state.[1]

All of the 34 states responding to the survey have stated that the legislation would adversely affect their business activity tax (BAT) revenue. The range of taxes affected is broad and includes gross receipts, gross income (including Washington State's Business and Occupation Tax), taxes imposed on vendors for the privilege of doing business, taxes on receipts of public utilities, and taxes imposed in lieu of net income taxes and similar types of taxes. Based on information from responding states, H.R. 1956 would reduce BAT revenues by an average of 10.4%. Extrapolating to all states, H.R. 1956 would cost states and localities an estimated *\$6.6 billion annually*.

Examples provided by responding states indicate H.R. 1956 would upset settled law regarding state business activities of numerous industries including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software. Sellers of services and intangibles would come under a new physical presence standard that exceeds the provisions in PL 86-272 for sellers of tangible personal property. This extension, along with other provisions in the bill, would create new opportunities for businesses to structure their operations so as to avoid most state business activity taxes entirely. Certain provisions, (e.g., the ability for other parties to perform work on the company's behalf, the 21 day exemption, and carve outs for specific industries) present likely sources of revenue impact.

Although the sponsors have indicated their bill would achieve the goal of creating legal certainty that would minimize litigation, it appears that H.R. 1956 could have the opposite effect. Opportunities for businesses to reorganize in order to avoid taxes would shift the areas of litigation to new ground. The reorganizations and perhaps physical relocations would also burden the economy as businesses expend resources for non-productive purposes. In addition, H.R. 1956 would legalize certain tax sheltering practices and income shifting methods that several states consider questionable.

In this survey, state revenue estimators were asked to estimate the revenue impact on their state in three ways – the static effect, dynamic effect, and compliance effect. A static effect captures how the new law would allow some companies, currently filing, to be free to stop filing. The dynamic or behavioral effect asks what happens to revenue when companies restructure or change operations to use the provisions of H.R. 1956 to minimize their BAT liability. The

[1] This survey was originally conducted in response to a virtually identical bill introduced during the 108th Congress, H.R. 3220, the "Business Activity Tax Simplification Act of 2003." Because of the similarity between the two bills, several states used their original estimates to calculate the impact of H.R. 1956.

compliance effect is the loss of anticipated revenue from enforcement efforts to curb current illegal tax sheltering or income shifting activities that would be made legal if the bill were to become law. The estimates for the dynamic effect are somewhat larger than for the static effect, although the dynamic effect includes a wider range of estimates, representing less certainty. The compliance effect is significantly smaller than the static or dynamic estimates.

As the report indicates, the federally mandated physical presence standard in H.R. 1956 would have a significant impact on the revenues of nearly every state. The bill's extension of the physical presence standard beyond tangible personal property sales, and its addition of carve outs and exemptions for certain industries and practices, only increase its adverse impact. Governors urge Congress to oppose H.R. 1956 and leave decisions regarding state revenues to the states.

I. Introduction and Draft Description of Survey

On April 28, 2005, H.R. 1956, titled the "Business Activity Tax Simplification Act of 2005" was introduced in Congress by Representatives Rick Boucher and Bob Goodlatte of Virginia. This bill is strikingly similar to H.R.3220, the "Business Activity Tax Simplification Act of 2003." introduced by Representatives Boucher and Goodlatte on October 1, 2003. The purposes of this proposed legislation, according to Representative Bob Goodlatte of Virginia are:

- To provide a "bright line" that clarifies state and local authority to collect business activity taxes from out-of-state entities.
- To set specific standards to govern when businesses should be obliged to pay business activity taxes to a state. Specifically, the legislation establishes a "physical presence" test such that an out-of-state company must have a physical presence in a state before the state can impose franchise taxes, business license taxes, and other business activity taxes.
- To ensure fairness, minimize litigation, and create the kind of legally certain and stable business climate that encourages businesses to make investments, expand interstate commerce, specifically electronic commerce, grow the economy and create new jobs.
- To ensure that states and localities are fairly compensated when they provide services to businesses with a physical presence in the state.[2]

Although the underlying premise – a uniform state business activity tax jurisdictional standard – may be desirable to some, this bill would, if enacted, have adverse impacts on state and local governments. In-depth analysis of this bill reveals that preemption of state and local authority would expand in four dimensions:

1) The bill would expand the type of taxes preempted from income taxes to a wide variety of state and local business activity taxes.
2) The bill would expand the range of businesses benefiting from the preemption of state and local authority from only businesses selling tangible goods to all businesses making sales, including the sale of services and intangibles.
3) The bill would impose new, broad restrictions on state jurisdictional authority for state and local business activity taxes by establishing a general physical presence standard of nexus for such taxes; and
4) The bill would provide for a wide variety of exceptions to physical presence: temporary and permanent physical activities in a state that would allow business entities to be exempt from a state and local business activity tax even if they had a physical presence in a jurisdiction.

The taxes affected by this proposed legislation include corporate income taxes and other business activity taxes (transactions taxes are not affected by the bill). Other business activity taxes include:[3]

[2] Remarks of Representative Bob Goodlatte, reprinted in ***State Tax Notes***, Doc 2005-9147, May 3, 2005, Tax Analysts, Inc., Arlington, VA

[3] H.R. 1956 Section 4(1) and 4(2)(A) and 4(2) (B).

- A tax imposed on or measured by gross receipts, gross income, or gross profits;
- A business license tax;
- A business and occupation tax;
- A franchise tax;
- A single business tax or a capital stock tax;
- Any other tax imposed by a state on a business for the right to do business in that state or measured by the amount of, or economic results of, business or related activity conducted in that state. [4]

Taxes on gross receipts, gross income, or gross profits include Washington State's Business and Occupation Tax, taxes imposed on vendors for the privilege of doing business at retail, taxes on receipts of public utilities and taxes imposed in lieu of net income taxes and similar types of taxes.[5] Business license taxes and business and occupation taxes include taxes and fees which are imposed on persons and businesses not domiciled in a state for the privilege of conducting business in that state. For example, a state may impose a license tax on out-of-state financial services companies, electricity marketers, and similar types of businesses for the privilege of conducting business in that state, regardless of whether these businesses have a physical presence, as defined in H.R. 1956, in that state. Local governments in that state that impose taxes similar to the ones illustrated above would be similarly prohibited from imposing these taxes. In 2004, state and local business activity taxes, using the definition of these taxes contained in the bill were $89.8 billion; or, 9.7 percent of state and local government tax revenues ($925.5 billion). In 2003, the estimated level of business activity taxes was $99.8 billion – 10.4 percent of state and local tax revenues – $964.2 billion.[6]

H.R. 1956 treats an individual's or an employee's presence in a state as not constituting physical presence if the individual or employee is in the state for 21 days or less, *for any purpose*. Similarly, a firm can have any amount of property in a state for 21 days or less and not have physical presence in a state. This proposed legislation would expand both the number and quality of contacts that an entity or individual can have in a state and still be exempt from that state's taxation. Some of the safe harbors would permit businesses to own property (in some cases, real property) in this state, for extended periods of time, without incurring a state tax liability. Additionally, H.R. 1956 would legalize certain tax shelters or income shifting methods that a number of states consider questionable.

Desirability of Physical Presence as the Nexus Standard for Business Activity Taxes

As Congressman Goodlatte correctly notes, the growth of the Internet increasingly enables companies to conduct transactions without the constraint of geopolitical boundaries. The growth of remote interstate business-to-business and business-to-consumer transactions raises questions

[4] Note that such taxes need not be levied on all businesses, but may be taxes for the right of doing business or earning income from particular activities. Examples include utility gross receipts taxes levied for the right of conducting telecommunications, electrical supply or similar activities.
[5] Insurance gross premiums taxes are not included in the possible list of state taxes that may be preempted by H.R. 1956 because it was conclnded by MTC legal staff that these taxes were protected by the McCarran-Ferguson Act.
[6] U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Products Accounts, http://www.bea.doc.gov/bea/dn/nipaweb/TableView.asp#Mid

over where multi-state companies should be required to pay corporate income and other business activity taxes.[7] Proponents of a physical presence based nexus standard assert that:

> "...Public Law 86-272 must be modernized to address the shift in the focus of the economy from goods to services and intangibles, the increased burdens being imposed by local taxing jurisdictions, and the proliferation of non-income based business activity taxes."[8]

Furthermore, the proponents of a physical presence based nexus standard assert that business firms receive benefits from state and local governments only in those states in which they have a physical presence, and that the business activity taxes imposed on firms with physical presence will adequately compensate those governments for the services provided to local businesses.[9]

There are, however, compelling arguments against a physical presence based nexus standard for business activity taxes in general and against H.R. 1956 in particular. Professor Charles McLure of the Hoover Institution Stanford University, argues that Public Law 86-272 does not provide a desirable basis for state business activity nexus. In an article in the December 2000 ***National Tax Journal***, Professor McLure states:

> "Current rules for determining income tax nexus fail miserably. P.L. 86-272 has been justified as needed to limit extra-territorial taxation and interference with interstate commerce, but it has no conceptual foundation. Instead it reflects the exercise of raw political power and prevents the assertion of nexus by states that should be able to collect income taxes from corporations deriving income from within their borders."[10]

The argument that *only* those business firms physically located in a state receive any benefits from state expenditures and therefore should not be required to pay business activity taxes in those states in which they do not have physical presence is not true. The Economics of Public Finance literature has a long history of defining and classifying types of public services and the most economically efficient ways of financing those expenditures. For example, the benefits of state and local expenditures shows that the benefits of those expenditures often "spillover" to other jurisdictions and accrue over long periods of time, thus making it nearly impossible to assign specific benefits to specific businesses or individuals.[11] In such cases, these generalized benefits are usually financed by generalized taxes, such as income taxes or other taxes measured by ability to pay.

Furthermore, firms with little or no physical presence in a state generally pay very little in the way of state and local business activity taxes to those jurisdictions.[12] Government benefits to business firms with a physical presence within a state are largely financed through property taxes

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[7] Goodlatte, *op. cit.*
[8] www.batsa.org.
[9] Remarks of Representative Bob Goodlatte, reprinted in ***State Tax Notes***, Doc 2005-9147, ***op. cit.***
[10] Charles McLure, "Implementing State Corporate Income Taxes in the Digital Age," ***National Tax Journal***, Volume LIII, No. 4, Part 3, December 2000, p. 1297.
[11] Wallace E. Oates, "An Essay on Fiscal Federalism," ***Journal of Economic Literature***, Vol. 37, September 1999, p. 1128.
[12] http://www.batsa.org/FAQ.htm#ANS17

on the business' real and tangible property and by sales/use taxes on the purchase of business inputs. Nationally, these taxes account for 38.6 and 24.8 percent relatively of state and local taxes imposed on businesses in fiscal year 2003. Business activity taxes in contrast accounted for 18.0 percent of state and local taxes imposed on businesses in that year.[13]

Even if Congress chooses to limit the nexus standard for business activity taxes to a physical presence based standard, the question arises: is enactment of H.R. 1956 the best method of achieving that goal? Supporters of H.R. 1956 assert that enactment of this bill would not result in any significant loss of revenues to states because businesses would not restructure in order to take advantage of the safe harbors contained in the bill.[14] However, a recent analysis by the Congressional Research Service on H.R. 3220 from the 108th Congress notes that:

> "The new regulations as proposed in H.R. 3220 would have exacerbated the underlying inefficiencies because the threshold for business — the 21-day rule, higher than currently exists in most states — would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 would have expanded the opportunities for tax planning and thus tax avoidance and possibly evasion." [15]

Preliminary Findings
A major finding of this survey is that if H.R. 1956 is enacted, the bill would upset settled law regarding state business activity taxation of numerous industries, including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software.

If H.R. 1956 is enacted the estimated revenue impact in fiscal year 2007, for the 34 states that have responded to the survey would range from approximately \$3.3 billion, or approximately 8.2 percent of projected business activity tax revenues in that year to \$5.5 billion, or approximately 12.7 percent of projected business activity tax revenues. The "best" estimate of the impact is approximately \$4.6 billion, or approximately 10.4 percent of projected business activity tax revenues in that year. Applying these proportionate revenue impacts to all states, the projected revenue impact in fiscal 2007 would range from \$4.7 billion to \$8.0 billion; the "best" estimate would be \$6.6 billion. The estimated revenue impacts would range from 8.2 percent of projected business activity tax revenue in fiscal year 2007 to 13.8 percent; the "best" estimate would be 11.4 percent (See Table 1).

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[13] Robert Cline, William Fox, Tom Neubig, and Andrew Phillips, "Total State and Local Business Taxes: A 50-State Study of the Taxes Paid by Business in Fiscal 2003," ***State Tax Notes***, Document 2004-1774, Tax Analysts, Inc., Arlington, VA, March 1, 2004, p. 738.
[14] http://www.batsa.org/FAQ.htm#ANS16
[15] Steven Maguire, ***State Corporate Income Taxes: A Description and Analysis***, CRS Report for Congress, Order Code RL32297, updated March 9, 2005, p.14.

Table 1: Estimated Revenue Impact of H.R. 1956 Fiscal Year 2007			
	Estimated Impact: Fiscal Year 2007		
Effect	Minimum Impact	Best Estimate	Maximum Impact
	(Millions)		
Total Effect	***$4,718.6***	***$6,588.3***	***$7,968.1***
Static Effect	2,216.7	2,639.4	3,061.5
Dynamic Effect	2,124.4	3,463.4	4,403.9
Compliance Effect	364.7	366.7	368.1
Effect	(Percent of Projected Business Activity Taxes)		
Total Effect	8.2%	11.4%	13.8%
Static Effect	3.3	4.1	4.7
Dynamic Effect	3.5	5.6	7.1
Compliance Effect	0.6	0.6	0.6
Sources: Multistate Tax Commission estimates based on State Revenue Agency responses to survey of potential impact of H.R. 1956 in fiscal year 2007; and, U.S. Department of Commerce, Bureau of the Census Bureau of Economic Analysis.			

Beyond the effect on revenue, H.R. 1956, if enacted, would cause a significant, but unmeasured burden on the economy. The special provisions of the bill would most likely induce a number of firms to reorganize in order to take advantage of those provisions. These reorganizations absorb the resources of the firms but would not result in greater efficiency or productivity. Furthermore, if business firms alter the location of existing plant and/or personnel to take advantage of the provisions of this bill, the result is economically inefficient locations of production.

Description of Survey

On April 23, 2004, the FTA and MTC sent a survey to each state asking them to estimate the impact of a federal physical presence standard, on their state. As of this date, 34 states have responded to the BAT survey. The survey instrument contains background explanation and staff analysis of the legislation, and four response sections:

1. *Section I. Legal and Enforcement Analysis.* This section asks for a complete list of each state's statutes and regulations that would be overturned if H.R. 1956 were enacted. The section consists of three parts:

<u>Part A</u>. – Identification of the type of tax to which the regulation or statute applies and the citation of the applicable provision.
<u>Part B</u>. – Provision of a brief factual description of court cases affected, including the type of tax and the amount of income and tax involved.
<u>Part C</u>. – Examples of current enforcement activity that would be precluded by H.R. 1956.

2. *Section II. The Revenue Estimate.* This section asks for estimates of the revenue impact of H.R. 1956 on each state. It asks state revenue estimators to estimate the impact on their state in three ways:
    - *Static effect*: Some companies that currently comply with state BAT laws would, under the new nexus standards, be free to stop filing.
    - *Dynamic or Behavioral effect*: Estimates the revenue effect when companies restructure or change operations to use the provisions of H.R. 1956 to minimize their BAT liability.
    - *Compliance effect*: The loss of anticipated revenue from enforcement efforts to curb current tax sheltering or income shifting activity.

Guidelines for estimating the revenue impact on state and local governments are included in this part.

3. *Section III. Case Study Examples of Inequitable Taxpayer Results That Would be Created by H.R. 1956.*

4. *Section IV. State Responses to Examples of "Horror" Stories Raised by Proponents of Physical Presence Nexus Standard.*

The remainder of this analysis presents the preliminary findings from state responses to two sections of the survey. First is the legal analysis portion, corresponding to Section I of the survey. Second is the revenue impact analysis, corresponding to Section II of the survey.

II: Preliminary Estimates of the Legal Impact of H.R. 1956

Preliminary Findings
This section summarizes the likely effects of H.R. 1956 on the states' existing authority under the Commerce Clause and/or PL 86-272 to impose a business activity tax on a multistate business. For the most part, the cases described below were identified by the states responding to the H.R. 1956 survey as likely to be affected should H.R. 1956 become law. In preparing this analysis, we have relied on the facts as determined in each case, rather than construct hypothetical factual scenarios against which the effects of H.R. 1956 are measured. Accordingly, this section is intended to present a real world analysis of H.R. 1956 by explaining how the results of actual cases are likely to be affected by the bill.

1. **H.R. 1956 will preempt the states' authority to impose a business activity tax on a company operating through a wholly owned dependent contractor.**

Currently, a business that solicits or makes sales through an independent contractor is within the PL 86-272 safe harbor. In order to be considered an independent contractor, the representative must have more than one principal. The RDA case described below is indicative of how H.R. 1956 would interact with current state law.

RDA is a Delaware corporation headquartered in New York State. It publishes and sells Reader's Digest. All sale orders are accepted and filled outside California. RDA does not own, lease or maintain any facilities or bank accounts in California, and has no California employees. Under these facts, the California FTB conceded that PL 86-272 preempted California from taxing RDA.

RDS&S, a wholly owned subsidiary of RDA, is a Delaware corporation that was headquartered in New York during the years at issue. RDS&S maintained two offices in California during the tax years in question and was subject to California franchise tax.

RDS&S solicited sales of advertising in domestic and foreign editions of Reader's Digest, on behalf of RDA and RDA subsidiaries that publish various editions of the magazine. It also solicited advertising sales on behalf of at least four foreign companies (in which RDA had no ownership interest) that published foreign language editions of Reader's Digest.

RDS&S was the only entity that sold or solicited the sale of advertising in the United States for any edition of Reader's Digest. RDA required all subsidiaries and foreign companies publishing the magazine to use RDS&S as their advertising broker in the United States. RDS&S did not solicit advertising sales on behalf of any publication other than Reader's Digest.

RDA reviewed and executed the RDS&S lease in California and administratively oversaw the properties of RDA subsidiaries. RDA performed accounting functions, administered the employee benefit plans and purchased all insurance for RDS&S. In its consolidated financial statements, RDA eliminated all "intercompany" net sales and operating revenue between RDS&S and RDA and its other affiliates, asserting that RDS&S was part of RDA's unitary business.

In *Reader's Digest Association, Inc. v. Franchise Tax Board,* 94 Cal. App. 4th 1240, 115 Cal. Rptr. 2d 53 (CA Ct. App. 2001), *review denied,* 2002 Cal. LEXIS 1786 (CA 2002), the California Court of Appeal ruled that RDS&S was not acting as an independent contractor within the meaning of PL 86-872 in selling advertising for RDA and other affiliates of RDA. Therefore, the Court held that RDA's income and sales factors were properly included in the unitary business apportionment formula on the California franchise tax return.

H.R. 1956 would overrule *Reader's Digest.* Section 3(b)(2) of the bill would allow a business to escape business activity tax in a state if it uses the services of another person to establish and maintain its market in the state, as long as the person performs similar functions on behalf of at least one other business entity during the taxable year. There is no requirement in H.R. 1956 that the business entities are unrelated or that the person is an independent contractor. Therefore, under the facts of *Reader's Digest,* California would be preempted from imposing its corporate franchise tax on RDA, notwithstanding that RDS&S only sold advertising on behalf of Reader's Digest and that, at least in the United States, all of RDS&S' clients were RDA affiliates.

2. H.R. 1956 will substantially preempt the states' authority to impose a properly apportioned income tax on interstate motor carriers.

McAdams, an Arkansas corporation, was an ICC-certified irregular route motor common carrier transporting commodities in interstate commerce. For the tax years in question, McAdams' percent of total miles traveled in Virginia to total miles traveled ranged from 1.23% to 3.14%. On average, its deliveries into Virginia from points outside the state ranged from 35 to 51 during the tax years at issue. Its pick-ups in Virginia for delivery outside the state during this period ranged from 1 to 9 per year. There were no intrastate pick-ups or deliveries and the interstate pick-ups and deliveries which either began or ended in Virginia constituted only 5% of the miles McAdams traveled within the state. The remaining 95 percent of the miles McAdams traveled in Virginia were "bridge miles."[16]

Virginia imposes a corporate income tax on the Virginia taxable income of every foreign corporation having income from Virginia sources. Income can be derived either from the ownership of any interest in real or tangible personal property in the state, or from a business, trade, profession or occupation carried on in the state. In the case of motor carriers, any carrier which travels less than 50,000 miles annually through Virginia or which makes fewer than twelve round trips annually into the state is excluded from the tax. McAdams exceeded these *de minimis* amounts in each of the years in question.

In applying its income tax to the income derived by interstate motor carriers within Virginia, the state uses an apportionment formula, the numerator of which is the total miles traveled in Virginia for the tax year and the denominator of which is the total miles traveled everywhere that year.

In *Virginia Department of Taxation v. B.J. McAdams, Inc.*, 227 Va. 548, 317 S.E.2d 788 (1984), the Virginia Supreme Court ruled that a properly apportioned income tax imposed on interstate motor carriers was consistent with the Commerce Clause.

In ruling that the Virginia tax was consistent with the Commerce Clause, the Virginia Supreme Court found sufficient nexus to impose the tax because of McAdams' use of the Virginia highway system, and the state's provision of police protection and similar benefits to the taxpayer.

H.R. 1956 would upset settled law in Virginia and in most states regarding the income taxation of interstate motor carriers doing business within the taxing state. The 21 day rule in Section 3(b) (1) and (2) would preempt a state from imposing a business activity tax on an interstate motor carrier that was present in the state for no more than 21 days in the taxable year, acting either through employees or through another person. Furthermore, if the interstate motor carrier utilized the services of another person who performed similar functions on behalf of at least one additional business entity during the taxable year, the state would be preempted from imposing business activity taxes on the carrier even if the other person were present in the taxing state for more than 21 days. (Section 3(b) (2)). As a result, an interstate motor carrier could structure

[16] "Bridge miles" consist of miles driven through a state from an origin outside the state to a destination outside the state, without any pick-ups or deliveries within the state.

itself so that its delivery affiliate performed similar functions exclusively for affiliated entities and immunize its entire income from state taxation.[17]

3. **H.R. 1956 would overrule established precedent by allowing businesses to engage in activities that are not ancillary to solicitation without incurring business active tax liability.**

The United States Supreme Court has ruled that activities that are not ancillary to sales solicitation – those activities that serve an independent business function apart from their connection to the soliciting of orders – do not come within the safe harbor from taxation established by PL 86-272. *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.,* 506 U.S. 214 (1992). Accordingly, such activities as a salesman's replacing stale product for a retailer, a salesman's storage of product other than samples or replacing product for the retailer for consideration all serve independent business functions apart from their connection to the soliciting of orders and take the business out of the PL 86-272 safe harbor.

H.R. 1956 would effectively overrule *Wrigley* because of the 21 day rule and/or excluding from the definition of "physical presence," persons performing similar functions on behalf of one additional business entity other than the taxpayer.

In *Chattanooga Glass Company v. Strickland,* 244 Ga. 603, 261 S.E. 2d 599 (1979), the Georgia Supreme Court ruled that an out-of-state bottle manufacturer exceeded the protection of PL 86-272 by engaging in certain in-state activities that were not incidental to solicitation. Among those activities were: (1) one or two visits to Georgia per year by the company's customer service personnel to, among other things, remedy customer problems with previously purchased bottles, (2) maintaining property in Georgia, in the form of containers to store broken glass for later use as raw material in the company's glass manufacturing operations, and (3) purchasing the broken glass for use as raw material. Any of these activities would be viewed as not ancillary to solicitation under the *Wrigley* test, whether or not performed by sales personnel.

H.R. 1956, Section 3(b) (1) (A) would allow Chattanooga Glass to remedy customer problems under these facts, because the employees were not present in the state for more than 21 days. Furthermore, the company could exceed the 21 day limit by forming an affiliate to resolve such problems, and still not create the requisite physical presence required by the bill, as long as the affiliate performed similar functions on behalf of one additional business entity, including another affiliate. Section 3(b)(2). Section 3(b)(3) (c), in conjunction with Section 3(b)(2), would allow the company to maintain containers for broken glass within the State and to purchase broken glass in Georgia without incurring business activity tax liability, as both activities can be viewed as establishing or maintaining a market in the state by securing a source of raw material.

4. **H.R. 1956 would upset longstanding settled law by extending PL 86-272 to taxes other than taxes on or measured by net income.**

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[17] The delivery affiliate itself would remain subject to state taxation, as long as it was present in the state for more than 21 days in a taxable year. But the corporate tax base would be substantially reduced.

Currently, PL 86-262 only applies to a "net income tax" which is defined as a tax imposed on or measured by net income. H.R. 1956 would greatly expand the range of state taxes preempted by PL 86-272. In addition to the net income tax, H.R. 1956 also applies to the other business activity taxes defined in Section 4(2) (A) of the bill. If enacted into law, this would have a profound effect on settled law regarding nexus to impose a state business activity tax other than a net income tax.

For example, the Washington business and occupation tax is imposed on "the act or privilege of engaging in business activities" in the state. The tax applies to the following activities in Washington: extracting raw materials, manufacturing, or making wholesale or retail sales. The measure of the selling tax is the "gross proceeds of sale" and the measure of the manufacturing tax is the value of the manufactured products.

In *Tyler Pipe Industries v. Washington Department of Revenue,* 483 U.S. 232 (1987), the United States Supreme Court ruled that the presence of one independent contractor soliciting sales from within the state was sufficient to establish nexus for Washington to impose its B&O tax on an out-of-state manufacturer. Tyler maintained no office, owned no property and had no resident employees in Washington. The solicitation of business in Washington was directed by executives whose offices were outside the State and by one in-state independent contractor.

H.R. 1956 would allow an out-of-state company to easily avoid Washington's B&O tax under the facts of *Tyler Pipe*. First, the Washington B&O tax would clearly be considered a business activity tax under H.R. 1956 Section 4(2) (A) (i), (iii) and (vi). If the independent contractor performed sales solicitation services for one additional business entity during the taxable year, Washington would be preempted from imposing its B&O tax on the company, even if Tyler Pipe utilized the services of the contractor 52 weeks per year. Section 3(b)(2).

Michigan's single business tax (SBT) would also be included in the definition of "other business tax" in Section 4(2)(A). Doing so would reverse longstanding current law. In *Gillette Company v. Michigan Department of Treasury,* 198 Mich. App. 303, 497 N.W. 2d 595 (MI Ct. App. 1993), *appeal denied,* 519 N.W. 2d 156, *reconsideration denied,* 521 N.W. 2d 612 (MI 1994), *cert. denied,* 513 U.S. 1103 (1995), the Michigan Court of Appeals ruled that Michigan's single-business tax was not a tax imposed on or measured by net income. Therefore, the tax was not included within the definition of "net income tax" set forth in PL 86-272.

H.R. 1956 Section 4(2) (A) (v) explicitly includes a single business tax within the definition of "other business activity tax" covered by the bill. As Gillette's activities in Michigan were limited to the solicitation of orders that were accepted and filled from outside the state, Section 2(a) of the bill would preempt Michigan from imposing its SBT on Gillette, thereby overruling the decision of the Michigan Court of Appeals.[18]

[18] The extension of PL 86 -272 to business activity taxes other than a net income tax would have broader ramifications than merely extending the statute's protection of solicitation activity to those taxes. As the discussion of *Chattanooga Glass* makes clear in the net income tax context, extending the statute's protection to other taxes will have similar consequences for those taxes where the business engages in substantial activities that are clearly not ancillary to solicitation.

5. **H.R. 1956 would substantially preclude a state from levying a business activity tax on or as a result of a sale of an intangible.**

Section 2(a) of H.R. 1956 extends the protection of PL 86-272 to the solicitation of services or intangibles, thereby expanding the existing safe harbor for sellers of tangible personal property to the entire economy.

In *Amway Corporation, Inc. v. Missouri Director of Revenue,* 794 S.W. 2d 666 (1990), the Missouri Supreme Court held that the sale of distributorships by Amway, a Michigan corporation, exceeded the safe harbor established by PL 86-272 for the solicitation of orders for tangible personal property. The Court found a distributorship to be a license sold for a fee by Amway for "the right to service … customers and sponsor … distributors." The Court further found the sale of such a right to constitute a nonexclusive franchise the sale of which is the sale of intangible personal property. As of 1980, the last tax year at issue, Amway had more than 35,000 Missouri distributors and realized more than $175,000 in income from the sale of Amway distributorships in Missouri.

H.R. 1956 would effectively overrule *Amway* because the State would be preempted from imposing a business activity tax on the sale of distributorships.

In addition, given the physical presence requirement of Section 3(b), a number of cases that have ruled that physical presence is not required for a state to have corporate income tax nexus with a Delaware trademark holding company would be overruled if the bill were to be enacted. *Geoffrey, Inc. v. South Carolina Tax Commission,* 437 S.E. 2d 13 (S.C.), *cert. denied,* 510 U.S. 992 (1993); *A&F Trademark, Inc., et al., v. North Carolina Secretary of Revenue,* 605 S.E. 2d 187 (NC Ct. App. 2004). The amount of "nowhere income" realized by PICs (passive investment companies) is enormous. For example, the local operating companies in *A&F Trademark* had claimed state income tax deductions of $301,067,619 in royalties and $ 122,031,344 in interest paid to PICs in 1994, accounting for 100% of the taxpayers' income for that year.

6. **H.R. 1956 arguably may preempt a state from imposing a vendor sales tax.**

H.R. 1956, Section 4(2) (B) excludes a transaction tax from the definition of "other business activity tax." But Section 4(2)(A)(i) specifically includes a tax imposed on or measured by gross receipts within the definition of "other business activity tax." In addition, Section 4(2)(A)(vi) includes within the definition of "other business activity tax" any tax imposed by a state on a business "for the right to do business in that state or measured by the amount of, or economic results of, business or related activity in that state." This creates an ambiguity as to whether a vendor sales tax is included within the definition of "other business activity tax." At the very least, this ambiguity will lead to litigation in those states that impose a gross receipts tax on a vendor for the privilege of engaging in retail sales.

Arizona imposes a privilege tax "measured by the amount or volume of business transacted .. on account of … business activity, and in the amounts to be determined by the application of rates against values, gross proceeds of sales or gross income ...." A.R.S. §42-5008A (2004). The tax is not a direct tax upon goods one sells; rather, it is a tax directly and specifically for the privilege of conducting business within Arizona. *Arizona Department of Revenue v. Robinson's Hardware,* 149 Ariz. 589, 721 P.2d 137 (AZ Ct. App. 1986). The Arizona retail transaction privilege tax appears to come within the scope of H.R. 1956, Sections 4(2) (A) (i) and (vi). If so, H.R. 1956 would arguably overrule *Arizona Department of Revenue v. O'Connor, Cavanaugh, Anderson, Killingsworth & Beshears,* 192 Ariz. 200, 963 P. 2d 279 (AZ Ct. App. 1997).

In *O'Connor,* the Arizona Court of Appeals ruled that an Indiana manufacturer of custom office furniture had sufficient nexus with Arizona for the state to impose its retail transaction privilege tax. Between February 1985 and April 1989, Dunbar, the Indiana furniture manufacturer, entered into eighteen contracts to manufacture, sell and install office furniture for a Phoenix law firm. Dunbar employees delivered the furniture, usually in Dunbar trucks, and installed it in the Phoenix law office. In addition, Dunbar dispatched employees to Arizona on three occasions over the life of a three-year warranty to perform warranty services. On two of those occasions, Dunbar employees spent a week or more at the firm's new offices to correct the problems.

On these facts, it is likely that Dunbar's employees did not spend more than 21 days in Arizona in any taxable year. If H.R. 1956 applies to Arizona's retail transaction privilege tax, Arizona would therefore be precluded from imposing its tax under Section 3(b) (1). In any event, an out-of-state vendor could easily restructure itself so as to provide delivery and installation services through another person under Section 3(b)(2) and engage in those activities on a tax-free basis even if those persons were present in Arizona for more than 21 days in a taxable year.

Furthermore, an out-of-state vendor can maintain tangible leased property in the taxing state indefinitely without exceeding the protection of H.R. 1956, as long as that property is used to furnish a service to the owner or lessee by another person. Section 3(b)(3)(A). This would arguably overrule the holding of the Arizona Court of Appeals in *Arizona Department of Revenue v. Care Computer Systems, Inc.,* 197 Ariz. 414, 4 P.3d 469 (AZ Ct. App. 2000).

Care Computer is a Washington corporation that sells and licenses computer hardware and software to nursing homes. During the audit period, Care engaged in approximately 180 transactions with Arizona nursing homes. The vast majority of Care's Arizona transactions were conducted by mail or telefax. Two of the transactions were leases and the rest were sales. One lease was for a general ledger program; the other was for three programs and a computer. At the end of both lease terms, the lessees bought the leased goods, and Care credited 75% of the lease payments to the sales prices. Total rental payments for the two transactions were $ 24,208.86.

Care had one salesperson assigned to Arizona who operated from California. He visited Arizona on seven occasions during the audit period, averaging one- to two-day visits each time. In addition, Care conducted training for its Arizona nursing home customers on 80 widely separated days of the 1370 days covered by the audit from July 1987 through March 1991, or an average of 24 days per year.[19]

[19] The 24 day average is not broken down by taxable year. It is quite possible that Care's training personnel were not present in Arizona in excess of 21 days per taxable year.

Care charged a license fee for its leased products. Approximately $105,000 of Care's income from Arizona transactions during the audit period consisted of software licensing fees.

Based on the above facts, the Arizona Court of Appeals found sufficient nexus for Arizona to impose the retail transaction privilege tax. If H.R. 1956 were to be enacted, the continued authority of *Care Computer* would be in doubt. It would be easy enough for a company to reorganize itself such that in-state training would be performed by another person within the meaning of Section 3(b)(2). The property would then be within the safe harbor of Section 3(b) (3) (a) as it would be used to furnish a service to the lessee of the property by another person.

Conclusion

If H.R. 1956 is enacted, there is substantial reason to believe that the bill would upset settled law regarding state business activity taxation of numerous industries, including publishing, interstate trucking, general and customized manufacturing, the sale of distributorships, licensing of trademarks, and leasing of computer hardware and software.

III: Preliminary Estimates of the Revenue Impact of H.R. 1956

1. **Preliminary Findings:**

Based on the results from the 34 responding states to date, the "best" estimate of the impact for ***all*** states in fiscal year 2007 is $6.6 billion.[20] The total effect in fiscal year 2007 is the sum of three effects, static effect, dynamic effect, and compliance effect, which are described below. Using the best estimates of state revenue agency personnel, the projected revenue impacts are: $3.0 billion; $4.2 billion; and $443 million from the static effect, the dynamic effect, and the compliance effect respectively.

The estimated total revenue impact of H.R. 1956 in fiscal year 2007 would range from $5.5 billion to $9.4 billion. The estimates of the static effect range from $2.5 billion to more than $3.5 billion; $3.0 billion is the best estimate. This relatively narrow range of the expected impact is based on the judgment of state revenue estimating personnel from their examination of business income tax returns. Conversely, the relatively wide range ($2.5 billion to $5.3 billion) of the estimated revenue impact resulting from expected changes in the response of business firms to the change in tax law – the dynamic effect – is based on state revenue agency staff projections of

[20] This estimate was derived by multiplying the estimate of the revenue impact of H.R. 1956 as a proportion of projected business activity tax revenues, as reported by the states, (14.1 percent) by the projected business activity tax revenue for all states in fiscal year 2007 – $57.7 billion. Business activity taxes are defined as: corporate franchise taxes, corporate income taxes, and Business and Occupation Taxes (Washington State), Single Business Tax (Michigan) and Use Tax in Illinois. These taxes were chosen to represent all business activity taxes because they were the ones estimated by the responding states. A more detailed explanation of how the weighted average was obtained is presented in the APPENDIX.

The estimates for U.S. business activity tax collections in 2007 were derived by projecting business activity tax revenues for fiscal years 1999, 2000, 2001, 2002 and 2003 through 2007 using straight line trends and growth trends and averaging those results. Data for state business activity taxes are from the U.S. Bureau of the Census, ***State Tax Collections*** for the various years.

business responses to H.R. 1956. The range of estimates of the compliance effect (approximately $418 million to approximately $445 million) is based on current enforcement actions that would not be taken if H.R. 1956 were to become law.[21]

State revenue agency personnel were asked to estimate the revenue impact of H.R. 1956 on their state's revenue in fiscal year 2007 and beyond. Fiscal year 2007 was chosen as the target year because it was assumed that, if enacted, H.R. 1956 would be in effect for fiscal years 2005 and beyond; and, that the revenue effects would not be significant until two years after the law was enacted. This time frame was considered sufficient for business firms to reorganize their operations in order to take advantage of the protections offered by H.R. 1956 to reduce their state business activity tax liabilities. However, preliminary responses from some states indicate that the revenue impact could increase significantly for fiscal years 2009 and beyond. For example, seven states, California, Delaware, Kentucky, New Jersey, Tennessee, Washington, and Wisconsin, provided estimates of the revenue impact for fiscal year 2009 as well as 2007. Using those states' "best" estimates, the total revenue impact for those states would increase from $1.8 billion to $2.5 billion – or 40.5 percent.

2. <u>Methods of Estimation:</u>

Revenue estimators projected the revenue impact of H.R. 1956 on their state by assuming that the impact would result from three simultaneously occurring effects:

- (*Static Effect*): Businesses that would no longer be subject to tax by the revenue estimator's state or localities under the new law because their physical presence in a state was below the threshold established by H.R. 1956 (21 days or fewer for property or personnel to be in a state); or, the firms engage in one of the protected activities.
- (*Dynamic Effect*): Businesses would, in response to the planning opportunities created by federal law, restructure or otherwise engage in tax planning to minimize their tax liability in the revenue estimator's state.
- (*Compliance Effect*): The loss of revenue that states had expected to gain from current enforcement activities with respect to non-complying businesses under current law, but which states would be barred from collecting because the federal law would bar further enforcement.

3. <u>Explanation and Examples of Effects:</u>

a) Static Effect   Estimating the Loss of Currently Collected Revenues

States can experience some immediate reduction in business activity tax revenue because some businesses that have no physical presence, or only minor physical presence. For example, businesses that may be seasonal or transient in nature, but are currently filing and remitting business activity taxes, will no longer be subject to business activity taxes because their level of

[21] The sum of the static effect, dynamic effect, and compliance effect will not add to the total effect because a few states provided estimates of the total effect only. No effort was made to allocate the total effect to each of the separate effects.

physical presence is below the level established by H.R. 1956 (21 days). Similarly, some businesses would be protected by the special protections offered by H.R. 1956, for example, their only physical presence is property being processed by a contract manufacturer, or their activity is limited to covering events for the media.

Estimates of the static effect were based on the assumption that those businesses that are currently remitting business activity taxes but have $0 or *de minimis* amounts of either property or payroll in the taxing state would not be subject to that state's business activity taxes. Revenue estimators used the dollar amounts of payroll or property in their state to estimate the impact of H.R. 1956 rather than the number of days each business had personnel or property in their state because the tax returns, and tax liabilities are based on the relative dollar levels of those factors. The de *minimis* level of the factors used to estimate the revenue impact is usually stated on the state response sheet. Not all states responding to the survey explicitly stated the level of payroll or property on which their estimate was based.

b) Dynamic Effect Estimating the Loss of Revenues from Business Tax Planning Permitted by H.R. 1956

One example of the dynamic effect of H.R. 1956 is a company setting up an affiliate for marketing in a state. That affiliate would have a permanent physical presence in the state. The company could also establish two wholesale or producer affiliates corresponding to different product lines of the company, both serviced by the marketing affiliate and neither having a physical presence in a state. While the marketing affiliate would have a presence in the state, the rest of the business or corporate structure would not be subject to business activity taxes. Transfer prices could be set so as to minimize the tax paid by the marketing affiliate. Alternatively, the marketing representative in a state might be an independent contractor, with the same result of exempting from tax the company that has set up the two affiliates corresponding to more than one product line. The independent contractor would be taxable, but the corporation whose products are being sold would not be.

Another, but somewhat more complex, example involves an out-of-state holding company that operates a number of stores in a state. The holding company could establish a management company remote from the states in which the stores are located. Similarly, the holding company could establish a staffing company that leases employees to the operating units (stores). Income could be shifted out of the state in which the stores operate by paying a "management fee" to the management company. The staffing company would also pay a fee to the management company further siphoning income from the state in which the stores operate. Furthermore, senior managers from the management company can work in the state with the operating company for fewer than 21 days without creating nexus for the management company.

H.R. 1956 can also negatively affect future revenues of state and local gross receipts, gross profits, or similar taxes. A business can reorganize in such a way to source sales into a state through entities that do not have nexus and thus are exempt from taxation in that state. All other activities that create and maintain the market in the market states that go beyond the protections provided by H.R. 1956 can be placed into separate entities. For example, a business can set up a wholesale or distribution subsidiary outside of the jurisdiction of the market state. By selling to independent contract marketers, as defined by H.R. 1956, in the market state, and through careful transfer pricing, the business can minimize its gross receipts tax liability in the market state.

There are other, more complex transactions and reorganizations that are available to many business firms. Because of the complexity of the dynamic effect, projecting the dynamic revenue impact estimates is a difficult process. This process requires revenue estimators to project the level of business activity taxes in the absence of H.R. 1956; and then to project how business taxpayers will respond to the new law.

An exposition of how multistate businesses can rearrange their organizations to take advantage of some of the provisions of legislation such as H.R. 1956 was presented by Joe Garrett of the Alabama Department of Revenue at MTC's 2004 Annual Meeting: http://www.mtc.gov/2004AnnualConferenceAgenda_files/Garrett.pdf.

c) Compliance Effect – Estimating the Loss of Anticipated Revenues from Compliance Activities that Would Be Blocked by H.R. 1956

Revenue estimators were asked to project the loss of future revenues from current enforcement efforts that would be blocked by H.R. 1956. These lost revenues would be in addition to the revenues lost from both the static and dynamic effects noted previously. For example, the estimator may project how much revenue the revenue estimator's state would lose in anticipated future revenue from enforcing a ruling in which the state court denied the tax effects of the use of intangible holding companies.

The compliance effect involves estimating revenues that are not yet in currently collected revenues, but are expected to be collected due to what the state considers to be sound compliance efforts. H.R. 1956 may result in legalizing activities that the revenue estimator's enforcement branch considers to be improper under current law and are now seeking to enforce. In these cases, H.R. 1956 will produce a loss of anticipated, but as yet not collected revenues.

4. **<u>State by State Estimates:</u>**

The respondent states were grouped into three categories: combined reporting states[22], separate entity states,[23] and special. Michigan and Washington State comprise the special category because their primary business activity taxes are the Single Business Tax and the Business and Occupation Tax respectively. For the percentage impact, the responses of the combined reporting states were added and that sum was divided by the sum of the corresponding responses for the estimated business activity taxes. As shown in Table 2 below, the minimum expected revenue impact of H.R. 1956 for the respondent states, as a percent of expected business activity tax revenue in 2007 is 7.6 percent. For combined reporting states, the expected impact is 2.3

[22] The combined reporting states are Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota, Oregon, and Utah. Combined reporting is a state tax accounting in which the taxable income of a single or unitary business operating in several states is apportioned among the states. The taxable income of the separate legal entities is added together.

[23] In separate entity states, the taxable income of each legal entity is apportioned among the states in which it operates.

percent, for separate entity states the expected impact is 11.0 percent, and for the special states, the impact is 14.4 percent.

Table 2
Estimate of Revenue Impact of H.R. 1956 on Respondent States: Fiscal Year 2007

Type of State	Minimum Impact	Best Estimate	Maximum Impact	Minimum Impact	Best Estimate	Maximum Impact
	(millions)			(Percent of Business Activity Tax)		
All States	$3,300.2	$4,558.3	$5,534.2	7.6%	10.4%	12.7%
Combined Reporting	443.6	523.0	608.6	2.3	2.7	3.2
Separate Entity	2,044.9	2,929.2	3,525.4	11.0	15.7	18.9
Special States (MI & WA)	811.6	1,106.1	1,400.2	14.4	19.6	24.8

Table 3 below presents estimates of the total revenue impact on states of H.R. 1956 in fiscal year 2007. National estimates were derived by assuming that each of the non-responding states would be affected by H.R. 1956 to the same extent as states that have similar tax structures. Thus, the estimates for each of the non-respondent combined reporting states were obtained by multiplying their estimated business activity tax revenue in 2007 by the respective percentage estimates -- 2.3 percent for the minimum impact, 2.9 percent for the "best" estimate, and 3.4 percent for the maximum expected impact. A similar procedure was performed on the non-respondent separate entity states.

The estimates for non-respondent states were then added to the estimates provided by the respondent states to obtain a national estimate. The higher percent estimates for the United States (13.5% best estimate) relative to respondent states (11.4% best estimate) is due to the over-representation of combined reporting states among the responding states. State-by-state estimates of each of the separate effects (static, dynamic, and compliance, and total effect) for fiscal year 2007 are contained in APPENDIX Tables A, B, and C. Table A contains estimates of the minimum impact H.R. 1956 would have on states, Table B is the "best" estimate, and Table C contains estimates of the maximum impact of H.R. 1956.

5. Notes on the Preliminary Estimates

The estimates of the revenue impact of H.R. 1956 do not take into account some states use a "throwback" rule or a "throwout" rule to minimize "nowhere" income.[24] The "throwback" rule affects the sales factor of the apportionment formula when sales are made by a seller into a state which has no jurisdiction to impose an income tax on the seller. Those sales are assigned back to the state from which the goods sold have been shipped. The "throwout" rule is similar to the "throwback" rule – sales into states that do not have authority to impose an income tax on the seller are removed from both the numerator and denominator of the sales factor of the apportionment formula.

[24] Income that is not sourced to any state. This can occur when a seller of tangible personal property has no nexus in a destination state, or a state is limited by the U.S. Constitution or statute from imposing a tax.

Also, the estimates of the revenue impact of H.R. 1956 are just that, estimates. Any imprecision of the estimates arise from the need to anticipate how those affected by the legislation will react. As George Yin, Chief of Staff of the Joint Committee on Taxation, stated at a conference in Los Angeles on March 1, 2004 regarding the Joint Committee's staff estimates of the revenue impact of federal legislation:

> "… it's certainly a very imprecise process. There is some science involved in it and clearly some art involved in it -- no question about it." [25]

Despite the presence of "throwback" or "throwout" rules, and the imprecision of making these types of estimates, it is clear that, should H.R. 1956 be passed into law, there would be a significant revenue impact on state and local governments.

TABLE 3
Estimated Revenue Impact of H.R. 1956 by State
Fiscal Year 2007

	Estimated Revenue Impact of H.R. 1956: Fiscal Year 2007[1]			Estimated Business Activity Tax Revenue F.Y. 2007[2]	Revenue Impact as Percent of Business Activity Tax Revenue		
	Minimum Impact	Best Estimate of Impact	Maximum Impact		Minimum Impact	Best Estimate of Impact	Maximum Impact
State	(millions)				(Percent)		
United States	***$4,718.6***	***$6,588.3***	***$7,968.1***	***$57,693.8***	***8.2%***	***11.4%***	***13.8%***
Alaska	5.1	5.1	5.1	505.0	1.0	1.0	1.0
Arkansas	63.0	92.5	96.0	256.0	24.6	36.1	37.5
California	150.0	150.0	150.0	7,344.0	2.0	2.0	2.0
Connecticut	101.9	119.4	136.8	381.7	26.7	31.3	35.8
Delaware	22.0	30.5	30.5	298.1	7.4	10.2	13.1
Georgia	30.9	30.9	30.9	511.2	6.0	6.0	6.0
Idaho	8.0	8.0	*8.0*	*1,009.1*	0.8	0.8	0.8
Illinois	91.0	91.0	91.0	8,564.3	1.1	1.1	1.1
Iowa	45.0	46.0	46.0	200.0	22.5	23.0	23.5
Kansas	31.2	31.2	31.2	286.1	10.9	10.9	10.9
Kentucky	125.2	212.4	259.3	593.4	21.1	35.8	43.7
Maryland	106.4	106.4	106.4	397.0	26.8	26.8	26.8
Massachusetts	91.0	137.0	183.0	1,572.0	5.8	8.7	11.6
Michigan	417.5	417.5	417.5	2,113.3	19.8	19.8	19.8
Minnesota	47.1	54.4	67.1	621.5	7.6	8.8	10.8
Missouri	173.6	173.6	173.6	437.1	39.7	39.7	39.7

[25] Kenneth A. Gary, "Yin Explains JCT Revenue Estimating Efforts," ***Tax Notes***, Tax Analyst, Inc., TNT 42-6, Arlington, VA, March 2, 2004.

TABLE 3
Estimated Revenue Impact of H.R. 1956 by State
Fiscal Year 2007

State	Estimated Revenue Impact of H.R. 1956: Fiscal Year 2007[1] Minimum Impact	Best Estimate of Impact	Maximum Impact	Estimated Business Activity Tax Revenue F.Y. 2007[2]	Revenue Impact as Percent of Business Activity Tax Revenue Minimum Impact	Best Estimate of Impact	Maximum Impact
	(millions)				(Percent)		
Montana	3.0	4.5	6.0	79.2	3.8	5.7	7.6
New Hampshire	58.4	58.4	58.4	281.0	20.8	20.8	20.8
New Jersey	398.3	398.3	398.3	2,791.0	14.3	14.3	14.3
North Carolina	58.5	345.5	345.5	1,352.5	4.3	25.5	34.8
North Dakota	3.5	5.2	6.8	46.0	7.6	11.2	14.8
Ohio	171.0	298.0	425.0	1,022.0	16.7	29.2	41.6
Oklahoma	31.8	31.8	31.8	172.0	18.5	18.5	18.5
Oregon	35.3	90.7	179.2	314.7	13.7	35.1	55.4
Pennsylvania	51.5	77.8	92.6	3,928.0	1.3	2.0	2.4
South Dakota	6.5	6.5	6.5	94.3	6.9	6.9	6.9
Tennessee	191.1	234.8	294.9	1,457.3	13.1	16.1	20.2
Texas	225.0	410.0	530.5	2,000.0	11.3	20.5	26.5
Utah	2.8	3.9	5.8	260.0	1.1	1.5	2.2
Virginia	0.0	0.0	0.0	420.2	0.0	0.0	0.0
Washington	394.1	688.6	982.7	3,543.8	11.1	19.4	27.7
West Virginia	102.2	127.8	153.3	199.8	51.2	64.0	76.7
Wisconsin	50.0	50.0	50.0	577.0	8.7	8.7	8.7
Other combined reporting states	32.6	38.5	49.5	1421.7	2.3	2.7	3.2
Other separate entity states	1385.7	1984.3	2592.1	12660.2	11.0	15.7	18.9

1. Data in italics were estimated by the Multistate Tax Commission.

2. Includes Corporate income taxes, corporate franchise taxes, Single Business Tax (MI), Business and Occupation Tax (WA), Use Tax, (IL) and Public utility gross receipts taxes

3. Other combined reporting states: Arizona, Colorado, Hawaii, Maine, Nebraska, Vermont.
4. Other separate entity states: Alabama, D.C., Florida, Indiana, Louisiana, Mississippi, Nevada, New Mexico, New York, Rhode Island, South Carolina, Wyoming.

Source: APPENDIX Tables 1A, 1B, and 1C.

TABLE 3
Estimated Revenue Impact of H.R. 1956 by State
Fiscal Year 2007

	Estimated Revenue Impact of H.R. 1956: Fiscal Year 2007[1]			Estimated Business Activity Tax Revenue F.Y. 2007[2]	Revenue Impact as Percent of Business Activity Tax Revenue		
	Minimum Impact	Best Estimate of Impact	Maximum Impact		Minimum Impact	Best Estimate of Impact	Maximum Impact
State	(millions)				(Percent)		

IV: Summary and Conclusion

The sponsors of H.R. 1956 assert that this proposed legislation would establish clear rules regarding state and local government authority to impose business activity taxes on businesses engaged in interstate commerce. According to the proponents of this legislation, such clarity would bring certainty for businesses regarding their potential tax liabilities when making business investment decisions. Reduction of uncertainty would, in the opinion of the sponsors, lead to greater investment and job growth. Similarly, the sponsors assert that states would benefit from greater certainty regarding their authority to impose business activity taxes on firms engaged in interstate commerce. One beneficial outcome of this legislation, in the opinion of the proponents of this legislation, would be reduced litigation over nexus.

However, as shown in section II of this report, responses by state revenue agency legal staffs show that they are uncertain as to how their statutes and regulations relating to their "doing business" standards would mesh with H.R. 1956. This uncertainty could result in *more* litigation regarding state authority to impose business activity taxes.

The "bright line" test, proposed by the sponsors of this legislation, for determining whether a state has the authority to impose its business activity tax on a firm is based on a concept of physical presence – property or personnel in a state for 21 days or more. A physical presence test for state and local authority to impose business activity taxes would result in non-neutrality in the tax treatment of local businesses relative to businesses without the minimum level of physical presence for nexus. Long-term trends show that the economy is becoming more service oriented and less oriented toward manufacturing and mercantile activities. Physical presence, however measured, is becoming less important for the delivery of services and intangibles. Thus, if business activity taxes are to tax income in a reasonable approximation where the income is earned, physical presence is essentially irrelevant. Furthermore, technological innovations such as the Internet allow merchants to sell their products and services anywhere without a physical presence in many of the locations in which they do business. Local businesses would be at a tax disadvantage relative to remote firms as they compete for the same market.

Some may argue that local business receives a greater level of benefits from local governments and thus should bear higher taxes. A valid counterargument is that the benefits of local government that benefit businesses directly – public infrastructure, and fire and police protection -- are paid by businesses primarily through taxes on the value of business property and on use taxes on their purchases of inputs. These taxes are imposed only on local businesses.

In addition, this physical presence standard may create more record keeping for companies as they must be cognizant of when their property or personnel cross the physical presence standard. State revenue agencies would also need to have access to those records in order to determine whether a firm meets the physical presence test. This is an added cost for both the business sector and revenue agencies.

Finally, H.R. 1956 would have a significant adverse revenue impact on state governments – between $4.7 billion and $8.0 billion in 2007 – at a time when state and local governments are faced with rising costs of Medicaid, homeland security, and education. State and local governments would be forced to increase other taxes, decrease expenditures, or find combinations of tax increases and expenditure cuts to make up for lost revenues.

In conclusion, enactment of H.R. 1956 into law would not necessarily result in greater certainty for businesses and states but could create more confusion and litigation regarding state authority to impose business activity taxes. In addition, the bill create would artificial barriers to the most efficient locations of investment and employment resulting in lower rates of economic growth, and impose significant fiscal costs on state and local government.

APPENDIX

Estimates of Business Activity Tax Revenue for Non-Respondent States, Fiscal Year 2007

As noted in the text, estimates of the revenue impact for the non-respondent states were derived by multiplying the estimated revenue impact of the static effect as a proportion of business activity tax revenue, the estimated revenue impact of the dynamic effect as a proportion of business activity tax revenue, the estimated revenue impact of the compliance effect as a proportion of business activity tax revenue, and the estimated revenue impact of the total effect as a proportion of business activity tax revenue of the respondent states. The respondent and non-respondent states were classified as combined reporting states, separate entity states, and "special states (WA & MI). The estimated revenue impact for each non-respondent separate entity state was derived by dividing each of the revenue impacts (static effect, dynamic effect, compliance effect, and total impact) of all respondent separate entity states by the sum of the business activity tax revenue for those states (see Table 1) and multiplying by the estimated business activity tax revenue of the non-respondent state. The same estimating procedure was used to estimate the revenue impact for non-responding combined reporting states. In mathematical notation, for a non-respondent separate entity state, the static effect is:

$$\mathbf{S_{nri} = \{\Sigma S_{ri}/\Sigma BAT_{ri}\} * BAT_{nri}}$$

Where: $\mathbf{S_{nri}}$ is the static effect in nonrespondent state, i

$\mathbf{\Sigma S_{ri}}$ is the sum of the static revenue impact of the respondent states

$\mathbf{\Sigma BAT_{ri}}$ is the sum of business activity tax revenue of the respondent states and

$\mathbf{BAT_{nri}}$ is the estimate business activity tax revenue for nonrespondent state i.

The procedure is repeated to estimate the dynamic impact, compliance impact, and total impact separately. The same procedures were used to estimate the revenue impacts on combined reporting states.

The estimated business activity tax revenue (BAT) for nonrespondent state (i) was derived by dividing each nonrespondent state's BAT in 2003 by the sum of the 2003 BAT for all nonrespondent states. The quotient was then multiplied by the difference between the estimated total BAT in fiscal year 2007 ($57.7 billion) and the sum of the BAT in 2007 of the respondent states ($43.6 billion). The difference between the BAT sums is $14.1 billion. Again, in mathematical notation the estimated 2007 BAT for a nonrespondent state is:

$$\mathbf{BAT_{nri} = (BAT2003_{nri}/\Sigma BAT2003_{nri}) * \$14.1\ billion}$$

Where:

$\mathbf{BAT_{nri}}$ is estimated business activity tax revenue of nonrespondent state (i) in 2007

$\mathbf{BAT2003_{nri}}$ is business activity tax revenue of nonrespondent state (i) in 2003

$\mathbf{\Sigma BAT2003_{nri}}$ is the sum of fiscal year 2003 business activity tax revenues of all nonrespondent states.

Appendix TABLE1A Estimated Revenue Impact of H.R. 1956 by State: Minimum Impact Fiscal Year 2007 Dollar Amounts iu Millions						
	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
*United States**	*$2,126.7*	*$2,124.4*	*$364.7*	*$4,718.6*	*$57,693.8*	*8.2%*
Responding States	$1,456.9	$1,507.6	$252.3	$3,300.26	$43,628.5	7.6%
Alaska[2]	5.1	n.r	n.r	5.1	505.0	1.0
Arkansas[3]	6.0	57.0	n.r.	63.0	256.0	24.6
California [4,5]	n.r	150.0	n.r.	150.0	7,344.0	2.0
Connecticut[6]	75.2	26.8	n.r.	101.9	381.7	26.7
Delaware[7]	n.r.	n.r.	n.r.	22.0	298.1	7.4
Georgia[8]	30.9	n.r.	n.r.	30.9	511.2	6.0
Idaho[4]	8.0	n.r.	n.r.	8.0	*1,009.1*	0.8
Illinois[9]	91.0	n.r.	n.r.	91.0	8,564.3	1.1
Iowa[4]	10.0	30.0	5.0	45.0	200.0	22.5
Kansas[8]	2.2	29.3	n.r.	31.5	218.5	14.4
Kentucky[10]	39.1	86.1	n.r.	125.2	593.4	21.1
Maryland[11]	66.7	39.7	n.r.	106.4	397.0	26.8
Massachusetts[12]	91.0	n.r.	n.r.	91.0	1,572.0	5.8
Michigan[13]	239.1	150.9	27.5	417.5	2,113.3	19.8
Minnesota[4]	30.0	7.5	9.7	47.1	621.5	7.6
Missouri[8]	173.6	n.r.	n.r.	173.6	437.1	39.7
Montana[4,14]	n.r.	n.r.	n.r.	3.0	79.2	3.8
New Hampshire[15]	n.r	n.r	n.r	58.4	281.0	20.8
New Jersey[16]	219.0	150.0	29.3	398.3	2,791.0	14.3
North Carolina[17]	8.5	50.0	n.r.	58.5	1,352.5	4.3
North Dakota[18]	3.3	n.r.	0.2	3.5	46.0	7.6
Ohio[19]	40.0	131.0	n.r.	171.0	1,022.0	16.7
Oklahoma[4,20]	3.2	28.6	n.r.	31.8	172.0	18.5
Oregon[21]	5.7	33.2	4.6	43.5	314.7	13.7
Pennsylvania	51.5	n.r	n.r	51.5	3,928.0	1.3
South Dakota[22]	0.1	6.4	n.r.	6.5	94.3	6.9
Tennessee[23]	46.0	145.1	n.r.	191.1	1,457.3	13.1
Texas[24]	25.0	70.0	130.0	225.0	2,000.0	11.3
Utah[3]	0.7	1.7	0.4	2.8	260.0	1.1
Virginia[25]	0.0	0.0	0.0	0.0	420.2	0.0

Appendix TABLE1A
Estimated Revenue Impact of H.R. 1956 by State: Minimum Impact
Fiscal Year 2007
Dollar Amouuts iu Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
Washington[26]	96.2	252.3	45.6	394.1	3,543.8	11.1
West Virginia[4]	56.4	45.8	n.r.	102.2	199.8	51.2
Wisconsin	30.0	45.8	n.r.	50.0	577.0	8.7
Other combined reporting states	11.0	15.9	1.0	32.6	1421.7	2.3
Other separate entity states	735.5	612.6	122.4.	1470.5	12660	11.0

* Estimate of revenue impact of H.R. 3220 on all states based on state responses to survey.

Data in italics estimated by Multistate Tax Commission.

n.r. Not reported separately.
1. Excluding effects of H.R. 3220.
2. Corporate income and Fish Landing taxes.
3. Corporate income taxes only.
4. Corporate income and franchise taxes only. BAT revenue for 2007 in CA estimated by MTC.
5. Business Activity Tax for 2007 estimated by Multistate Tax Commission.
6. Includes Corporation Business Tax and Business Entity Tax.
7. Includes corporation income tax and gross receipts tax.
8. Includes Income Tax, franchise tax, and financial institutions tax. Georgia estimates are for 2003 only.
9. Includes Corporate Income and Replacement Tax, Use Tax, and Telecommunications Taxes."
10. Includes Corporate Income Tax, Corporate Franchise Tax, Bank Franchise Tax, Cigarette Taxes and fees, and Alcoholic Beverage Taxes.
11. Corporate income tax only. Assumes dynamic effect of H.R. 3220 would be 10 percent of estimated 2007 corporate income tax revenues.
12. Fiscal year 2006. Includes General business corporations tax, and financial institutions tax.
13. Single Business Tax only.
14. Midpoints of estimated range of impacts. BAT revenue for 2007 estimated by the Multistate Tax. Commission.
15. Includes Business Profits Tax, Business Enterprise Tax, and Communications Excise Tax. Estimates based on analysis of H.R. 2526, July 2002.
16. Includes corporate net income tax and Alternative Minimum Tax.
17. Includes corporate income, franchise, and personal income taxes.
18. Corporate income taxes and gross receipts taxes on telecommunications.
19. Corporate income (franchise) tax, tax on dealers of intangibles, and pass-through entities.
20. Estimates of compliance effect included in static effect estimates.

ANALYSIS OF H.R. 1956: SEPTEMBER 26, 2005

Appendix TABLE1A						
Estimated Revenue Impact of H.R. 1956 by State: Minimum Impact						
Fiscal Year 2007						
Dollar Amouuts iu Millions						
	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)

21. State only. Corporate income and excise taxes only.
22. Bank Tax only
23. Includes Excise & Franchise Tax, Local Business Tax, and Professional Privilege Tax.
24. Corporate Franchise Tax only.
25. Reported only minor revenue impact because physical presence is nexus standard.
26. State and local Business & Occupation Tax and State and local Public Utility Taxes.

Appendix TABLE 1B
Estimated Revenue Impact of H.R. 1956 by State: Best Estimates
Fiscal Year 2007
Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
United States*	*$2,639.4*	*$3,463.4*	*$366.7*	*$6,588.3*	*$57,693.8*	*11.4%*
Responding States	$1,782.3	$2,429.3	$253.3	$4,558.3	$43,628.5	11.4%
Alaska[2]	5.1	n.r	n.r	5.1	505.0	1.0
Arkansas[3]	9.5	83.0	n.r.	92.5	256.0	36.1
California [4,5]	n.r	150.0	n.r.	150.0	7,344.0	2.0
Connecticut[6]	88.1	31.2	n.r.	119.4	381.7	31.3
Delaware[7]	n.r.	n.r.	n.r.	30.5	298.1	10.2
Georgia[8]	30.9	n.r.	n.r.	30.9	511.2	6.0
Idaho[4]	8.0	n.r.	n.r.	8.0	*1,009.1*	0.8
Illinois[9]	91.0	n.r.	n.r.	91.0	8,564.3	1.1
Iowa[4]	10.0	30.0	6.0	46.0	200.0	23.0
Kansas[8]	4.4	58.6	n.r.	63.0	218.5	28.8
Kentucky[10]	65.7	146.7	n.r.	212.4	593.4	35.8
Maryland[11]	66.7	39.7	n.r.	106.4	397.0	26.8
Massachusetts[12]	137.0	n.r.	n.r.	137.0	1,572.0	8.7
Michigan[13]	239.1	150.9	27.5	417.5	2,113.3	19.8
Minnesota[4]	37.3	7.5	9.7	54.4	621.5	8.8
Missouri[8]	173.6	n.r.	n.r.	173.6	437.1	39.7
Montana[4,14]	n.r.	n.r.	n.r.	4.5	79.2	5.7
New Hampshire[15]	n.r	n.r	n.r	58.4	281.0	20.8
New Jersey[16]	219.0	150.0	29.3	398.3	2,791.0	14.3
North Carolina[17]	8.5	337.0	n.r.	345.5	1,352.5	25.5
North Dakota[18]	5.0	n.r.	0.2	5.2	46.0	11.2
Ohio[19]	40.0	258.0	n.r.	298.0	1,022.0	29.2
Oklahoma[4,20]	3.2	28.6	n.r.	31.8	172.0	18.5
Oregon[21]	8.2	98.6	4.6	90.7	314.7	35.1
Pennsylvania	77.8	n.r.	n.r.	77.8	3,928.0	2.0
South Dakota[22]	0.1	6.4	n.r.	6.5	94.3	6.9
Tennessee[23]	55.7	179.1	n.r.	234.8	1,457.3	16.1
Texas[24]	155.0	125.0	130.0	410.0	2,000.0	20.5
Utah[3]	1.5	2.0	0.4	3.9	260.0	1.5
Virginia[25]	0.0	0.0	0.0	0.0	420.2	0.0

ANALYSIS OF H.R. 1956: SEPTEMBER 26, 2005

Appendix TABLE 1B

Estimated Revenue Impact of H.R. 1956 by State: Best Estimates

Fiscal Year 2007

Dollar Amounts in Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
Washington[26]	138.4	504.6	45.6	688.6	3,543.8	19.4
West Virginia[4]	72.3	55.5	n.r.	127.8	199.8	64.0
Wisconsin	30.0	20.0	n.r.	50.0	577.0	8.7
Other combined reporting states	*11.7*	*21*	*1*	*33.7*	1421.7	*2.7*
Other separate entity states	*842.6*	*1009.9*	*112.2*	*1964.7*	12660	*15.7*

* Estimate of revenue impact of H.R. 3220 on all states based on state responses to survey.

Data in italics estimated by Multistate Tax Commission.

n.r. Not reported separately.

1. Excluding effects of H.R. 3220.
2. Corporate income and Fish Landing taxes.
3. Corporate income taxes only.
4. Corporate income and franchise taxes only. BAT revenue for 2007 in CA estimated by MTC.
5. Business Activity Tax for 2007 estimated by Multistate Tax Commission.
6. Includes Corporation Business Tax and Business Entity Tax.
7. Includes corporation income tax and gross receipts tax.
8. Includes Income Tax, franchise tax, and financial institutions tax. Georgia estimates are for 2003 only.
9. Includes Corporate Income and Replacement Tax, Use Tax, and Telecommunications Taxes."
10. Includes Corporate Income Tax, Corporate Franchise Tax, Bank Franchise Tax, Cigarette Taxes and fees, and Alcoholic Beverage Taxes.
11. Corporate income tax only. Assumes dynamic effect of H.R. 3220 would be 10 percent of estimated 2007 corporate income tax revenues.
12. Fiscal year 2006. Includes General business corporations tax, and financial institutions tax.
13. Single Business Tax only.
14. Midpoints of estimated range of impacts. BAT revenue for 2007 estimated by the Multistate Tax Commission.
15. Includes Business Profits Tax, Business Enterprise Tax, and Communications Excise Tax. Estimates based on analysis of H.R. 2526, July 2002.
16. Includes corporate net income tax and Alternative Minimum Tax.
17. Includes corporate income, franchise, and personal income taxes.
18. Corporate income taxes and gross receipts taxes on telecommunications.
19. Corporate income (franchise) tax, tax on dealers of intangibles, and pass-through entities.

Appendix TABLE 1B						
Estimated Revenue Impact of H.R. 1956 by State: Best Estimates						
Fiscal Year 2007						
Dollar Amounts in Millions						
	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
20. Estimates of compliance effect included in static effect estimates.						
21. State only. Includes corporate income and excise taxes only.						
22.Bank Tax only						
23. Includes Excise & Franchise Tax, Local Business Tax, and Professional Privilege Tax.						
24. Corporate Franchise Tax only.						
25. Reported only minor revenue impact because physical presence is nexus standard.						
26. State and local Business & Occupation Tax and State and local Public Utility Taxes.						

Appendix TABLE 1C
Estimated Revenue Impact of H.R. 1956 by State: Maximum Impact
Fiscal Year 2007
Dollar Amounts iu Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
*United States**	*$3,061.5*	*$4,403.9*	*$368.1*	*$7,968.1*	*$57,693.8*	*13.8%*
Responding States	$2,060.9	$3,115.6	$254.3	$5,534.2	$43,628.5	12.7%
Alaska[2]	5.1	n.r	n.r	5.1	505.0	1.0
Arkansas[3]	12.0	84.0	n.r.	96.0	256.0	37.5
California [4,5]	n.r	150.0	n.r.	150.0	7,344.0	2.0
Connecticut[6]	101.1	35.7	n.r.	136.8	381.7	35.8
Delaware[7]	n.r.	n.r.	n.r.	30.5	298.1	13.1
Georgia[8]	30.9	n.r.	n.r.	30.9	511.2	6.0
Idaho[4]	8.0	n.r.	n.r.	8.0	1,009.1	0.8
Illinois[9]	91.0	n.r.	n.r.	91.0	8,564.3	1.1
Iowa[4]	10.0	30.0	6.0	46.0	200.0	23.5
Kansas[8]	5.7	25.5	n.r.	31.2	286.1	10.9
Kentucky[10]	80.6	178.7	n.r.	259.3	593.4	43.7
Maryland[11]	66.7	39.7	n.r.	106.4	397.0	26.8
Massachusetts[12]	183.0	n.r.	n.r.	183.0	1,572.0	11.6
Michigan[13]	239.1	150.9	27.5	417.5	2,113.3	19.8
Minnesota[4]	50.0	7.5	9.7	67.1	621.5	10.8
Missouri[8]	173.6	n.r.	n.r.	173.6	437.1	39.7
Montana[4,14]	n.r.	n.r.	n.r.	6.0	79.2	7.6
New Hampshire[15]	n.r	n.r	n.r	58.4	281.0	20.8
New Jersey[16]	219.0	150.0	29.3	398.3	2,791.0	14.3
North Carolina[17]	8.5	337.0	n.r.	345.5	1,352.5	34.8
North Dakota[18]	6.6	n.r.	0.2	6.8	46.0	14.8
Ohio[19]	40.0	385.0	n.r.	425.0	1,022.0	41.6
Oklahoma[4,20]	3.2	28.6	n.r.	31.8	172.0	18.5
Oregon[21]	14.0	160.5	4.6	179.2	314.7	55.4
Pennsylvania	92.6	n.r.	n.r.	92.6	3,928.0	2.4
South Dakota[22]	0.1	6.4	n.r.	6.5	94.3	6.9
Tennessee[23]	62.3	232.6	n.r.	294.9	1,457.3	20.2
Texas[24]	255.0	145.5	130.0	530.5	2,000.0	26.5
Utah[3]	2.4	3.0	0.4	5.8	260.0	2.2
Virginia[25]	0.0	0.0	0.0	0.0	420.2	0.0
Washington[26]	182.2	754.9	45.6	982.7	3,543.8	27.7

Appendix TABLE 1C

Estimated Revenue Impact of H.R. 1956 by State: Maximum Impact

Fiscal Year 2007

Dollar Amounts iu Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)
West Virginia[4]	88.1	65.2	n.r.	153.3	199.8	76.7
Wisconsin	30.0	20.0	n.r.	50.0	577.0	8.7
Other combined reporting states	*13.3*	*35.4*	*1*	*49.7*	1421.7	*3.2*
Other separate entity states	*989.8*	*1267.4*	*113.1*	*2370.3*	12660	*18.9*

* Estimate of revenue impact of H.R. 3220 on all states based on state responses to survey.

Data in italics estimated by Multistate Tax Commission.

n.r. Not reported separately.

1. Excluding effects of H.R. 3220.
2. Corporate income and Fish Landing taxes.
3. Corporate income taxes only.
4. Corporate income and franchise taxes only. BAT revenue for 2007 in CA estimated by MTC.
5. Business Activity Tax for 2007 estimated by Multistate Tax Commission.
6. Includes Corporation Business Tax and Business Entity Tax.
7. Includes corporation income tax and gross receipts tax.
8. Includes Income Tax, franchise tax, and financial institutions tax. Georgia estimates are for 2003 only.
9. Includes Corporate Income and Replacement Tax, Use Tax, and Telecommunications Taxes."
10. Includes Corporate Income Tax, Corporate Franchise Tax, Bank Franchise Tax, Cigarette Taxes and fees, and Alcoholic Beverage Taxes.
11. Corporate income tax only. Assumes dynamic effect of H.R. 3220 would be 10 percent of estimated 2007 corporate income tax revenues.
12. Fiscal year 2006. Includes General business corporations tax, and financial institutions tax.
13. Single Business Tax only.
14. Midpoints of estimated range of impacts. BAT revenue for 2007 estimated by the Multistate Tax Commission.
15. Includes Business Profits Tax, Business Enterprise Tax, and Communications Excise Tax. Estimates based on analysis of H.R. 2526, July 2002.
16. Includes corporate net income tax and Alternative Minimum Tax.
17. Includes corporate income, franchise, and personal income taxes.
18. Corporate income taxes and gross receipts taxes on telecommunications.
19. Corporate income (franchise) tax, tax on dealers of intangibles, and pass-through entities.
20. Estimates of compliance effect included in static effect estimates.

Appendix TABLE 1C
Estimated Revenue Impact of H.R. 1956 by State: Maximum Impact
Fiscal Year 2007
Dollar Amounts iu Millions

	Static Effect	Dynamic Effect	Compliance Effect	Total Effect	Estimated Business Activity Tax Revenue[1]	Effect of H.R.1956 on BAT
	(1)	(2)	(3)	(4)	(5)	(6)
State				(1)+(2)+(3)		(4)/(5)

21. State only. Corporate income and excise taxes only.
22.Bank Tax only
23. Includes Excise & Franchise Tax, Local Business Tax, and Professional Privilege Tax.
24. Corporate Franchise Tax only.
25. Reported only minor revenue impact because physical presence is nexus standard.
26. State and local Business & Occupation Tax and State and local Public Utility Taxes.

May 4, 2011

U.S. House of Representatives
Washington, DC 20515

Re: Unions Urge "No" Vote on "Business Activity Tax Simplification Act of 2011", H.R. 1439

Dear Representative:

The undersigned labor unions urge you to oppose the "Business Activity Tax Simplification Act of 2011" (BATSA), H.R. 1439.

Our unions oppose this troubling proposal because it would impose an unfunded mandate and shrink state and local government tax revenues. Now is the wrong time to reduce state and local revenues. Several years ago, experts estimated these revenues would decline by at least $3 billion to $8 billion per year. Today, the revenue loss would be significantly larger. H.R. 1439 would limit state and local governments from determining and keeping their own tax systems, and it encourages and rewards businesses and large profitable corporations for making business decisions designed to aggressively avoid taxes. The Congressional Budget Office (CBO) has stated BATSA, "would amend current law to prohibit state and local governments from taxing certain business activities that are currently taxable." H.R. 1439 is worse than its predecessors in prior Congresses. H.R. 1439 now has an added provision limiting state authority to impose combined reporting, which previously would have partially counteracted the effects of earlier versions of this bill.

H.R. 1439 is designed to reduce business taxes now being paid to states and localities. It would prohibit states and localities from imposing existing taxes on legitimate business activity in the state and/or locality by creating a new physical presence rule, which would significantly weaken the "economic nexus" standard currently used. It also would prohibit states and localities from imposing certain business taxes on services, intangibles, media and financial services. While Public Law 86-272 currently prohibits jurisdictions from imposing taxes on the sale of goods, current law permits jurisdictions to impose taxes on the sales of services and intangibles. H.R. 1439 also prohibits states and localities from continuing to impose many existing business taxes. While Public Law 86-272 currently prohibits jurisdictions from imposing a corporate income tax, current law permits jurisdictions to impose other business taxes such as a gross sales tax or value added tax.

H.R. 1439 would inflict significant budget problems on state and local governments. Given the current revenue problems afflicting most states and localities, it's an especially bad time to preempt state and local tax authority and further reduce revenues. CBO's July 11, 2006 Cost Estimate for an earlier version of BATSA reported "the costs –

in the form of forgone revenues – to state and local governments would exceed $1 billion in the first full year after enactment and would likely grow to about $3 billion, annually, by 2011." CBO also determined BATSA (then H.R. 1956) is an unfunded mandate – "by prohibiting state and local governments from taxing certain business activities, H.R. 1956 would impose an intergovernmental mandate as defined in the Unfunded Mandates Reform Act (UMRA)." This unfunded mandate and $3 billion annual loss would worsen state and local budget problems and force cuts to education, health care, job creation and other vital services. Worse, CBO reports revenue losses would be concentrated in several states – "while virtually all states would lose revenues, about 70 percent of the estimated losses would come from ten states: California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington."

Some corporations design their operations to avoid nexus in states where they earn profits and produce a self-serving paper trail of "nowhere" income – to try to prevent states from taxing their income. H.R. 1439 would protect these tax shelters, increase their quantity and dollar value of tax shelters and tax shielding, and reward these tax avoidance actions. Large profitable corporations will take advantage of these combined practices to shift the tax burden further onto state and local residents.

We urge Congress to oppose preempting state and local government taxing authority and preventing them from creating viable and equitable tax systems.

Sincerely,

American Federation of State, County and Municipal Employees
AFL-CIO
Communication Workers of America (CWA)
International Federation of Professional and Technical Engineers (IFPTE), AFL-CIO
National Education Association
American Federation of Teachers
Department for Professional Employees, AFL-CIO
International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW)
International Association of Fire Fighters (IAFF)
Service Employees Union International (SEIU)