CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org www.cbpp.org

Revised May 9, 2005

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

By Michael Mazerov

Appendix:

What Would H.R. 1956 Actually Do? What Kind of Tax-avoidance Opportunities Would Its Enactment Open Up?

The "nexus" threshold is the minimum amount of activity a business must have in a particular state to be subject to taxation in that state. Nexus thresholds are established in the first instance by state law; state laws imposing the corporate income tax and similar "business activity taxes" (BATs) define the nature or level of activity conducted in the state that obligates a business to pay the tax. However, the Commerce Clause of the U.S. Constitution grants Congress the authority to preempt these laws.

In lobbying for the enactment of H.R. 1956, organizations representing major multistate corporations purport to be seeking federal legislation that would invalidate any portion of a state's existing nexus law that imposes a BAT on a business with less than a "physical presence" within the state. The bill provides that "No taxing authority of a State shall have power to impose, assess, or collect a net income tax or other business activity tax on any person relating to such person's activities in interstate commerce unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed."[26] The claim that business seeks no more than a "physical presence" BAT nexus threshold is highly misleading however, because H.R. 1956 goes on to create numerous nexus "safe harbors" — types of clear and substantial physical presence a business could have in a state that nonetheless would be deemed insufficient to obligate the business to pay a BAT.

Extending Federal Public Law 86-272 to the Service Sector and to Non-Income Based Taxes

One of the new nexus safe harbors that would be enacted in H.R. 1956 is an expansion of an existing federal law, Public Law 86-272. P.L. 86-272 was enacted in 1959 and intended to be a temporary moratorium on the ability of states to impose corporate profits taxes on certain out-of-state corporations; however, the law was never repealed.[27] P.L. 86-272 decrees that a state may not impose a corporate profits tax on an out-of-state corporation if:

- the corporation's only activity within the state is *soliciting orders* for the sale of *physical goods*, and

- the orders are approved at an out-of-state office of the seller, and

- the goods are shipped into the purchaser's state from an out-of-state location.

P.L. 86-272 clearly represents a nexus safe harbor because 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.[28] In the absence of Public Law 86-272, the regular presence of a salesperson in a state would be sufficient to obligate the corporation employing her to pay some income tax to that state (assuming that the corporation was profitable). P.L. 86-272 also allows a corporation to have an unlimited number of its own trucks plying the roads of a state loaded with an unlimited amount of company-owned goods en route to customers and yet still not be subject to corporate income tax in such a state. Finally, P.L. 86-272 permits companies to provide their sales forces with company-owned cars, product samples, computers, telephones, furniture, and similar equipment without thereby establishing corporate income tax nexus in the states where the salespeople solicit business.[29]

H.R. 1956 substantially expands the coverage of P.L. 86-272 along two dimensions. First, the bill extends P.L. 86-272 to protect from taxation corporations soliciting sales of both services and intangible property. If H.R. 1956 were enacted, for example:

- A Delaware bank could send an unlimited number of loan officers into Maryland to visit Maryland businesses and encourage them to borrow from the bank, yet incur no obligation to pay a tax to Maryland on the portion of the bank's profit attributable to its interest earnings on loans to Maryland borrowers.[30]

- A New York-based television network could send an unlimited number of advertising salespeople to visit major corporations headquartered in other states to solicit their purchases of air time without establishing BAT nexus in those states.

- A franchisor like Dunkin' Donuts 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.

Second, H.R. 1956 extends the protections of P.L. 86-272 to taxes other than corporate income taxes. Such taxes would include the

- Washington state Business and Occupations Tax (a generalized tax on business gross receipts),

- Michigan Single Business Tax (a form of value-added tax),

- Delaware Merchants' and Manufacturers' License Taxes (gross receipts),

- New Hampshire Business Enterprise Tax (value-added), and
- Texas Franchise Tax (net worth component).

Blocking a State from Taxing Virtually Any Corporation that Does Not Need to Maintain a Permanent "Brick and Mortar" Facility within the State's Borders

In order to interact with their customers and/or produce their goods and services, many kinds of businesses find it necessary to send employees and/or equipment, materials, and inventory they own into states in which they do not actually maintain offices, stores, warehouses, factories, or other permanent facilities. Such interstate activity is particularly common where a major metropolitan area lies in a multistate region, such as the Maryland/DC/Virginia area or the New Jersey and Connecticut suburbs close to New York City.

The following are just a few examples of the myriad ways in which businesses conduct interstate commerce without establishing a permanent physical presence in another state:

- Television broadcasters and movie studios may enter states temporarily to shoot programs, make movies, or cover sporting events.
- Business equipment manufacturers and software companies may find it necessary to visit their customers' place of business to install, calibrate, maintain, and repair the products they sell and train customer personnel in how to use them.
- Construction companies and construction subcontractors may send skilled workers, heavy equipment, and temporary office trailers to a construction site of a commercial building, a highway project, or a residential development.
- In the course of designing a new corporate headquarters building for a client, an architecture firm may send architects to consult with executives of the client at the current headquarters, and then have the architects monitor the construction process.
- Advertising agency personnel may meet with a client at the client's place of business and enter a state temporarily to take photographs or film commercials.
- A record company may sponsor a concert tour of an artist under contract and lease the sound equipment and vehicles that move the artist and concert support personnel from city to city. Record company employees may enter a state temporarily to monitor the making of a new recording at a particular studio or mixing facility.

- A manufacturing corporation may transport partially-manufactured goods into another state for further processing or assembly by another company, while retaining ownership of such "work in process inventory."

- In order to get products into the hands of customers more quickly or inexpensively, an Internet merchant or an industrial parts supplier may store inventory it owns at a warehouse operated by Federal Express or another company in the so-called "logistics industry" and contract with that company to deliver the goods to purchasers on command.

A profit-making corporation that sent employees and/or property into a state to conduct any of these kinds of activities would almost certainly have sufficient physical presence within the state to be subject to that state's corporate income tax or other BAT if the state chose to impose it. That would be true even of a seller of services newly covered by H.R. 1956'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."

Under H.R. 1956, however, all of the corporations in these examples likely could arrange their affairs to avoid income tax liability to any state in which they did not maintain a permanent, "brick-and-mortar" facility — regardless of how often they sent employees and/or property into such a state. A number of provisions of H.R. 1956 would interact to provide protection from nexus for these kinds of activities and companies.

The 21-Day Physical Presence Safe Harbor

First, H.R. 1956 provides that "physical presence" sufficient to establish BAT nexus is not established by the in-state presence of property and/or employees for 21 or fewer days in a taxpayer's taxable year. This 21-day limit can easily be circumvented, as will be discussed below. Even taken at face value, however, it likely would immunize a large number of corporations from BAT nexus in a significant number of states where the current language of P.L. 86-272 would not.

Since P.L. 86-272 was enacted, states have had to initiate considerable litigation to counteract claims by corporations that numerous activities the corporations engage in within states are subsumed in protected "solicitation." Indeed, multistate corporations attempted to sweep so many activities into "solicitation" that the Multistate Tax Commission (a joint agency of state revenue departments) was compelled to develop a detailed list of typical cross-border business activities that the states considered not to be protected by P.L. 86-272 and to put corporations on notice that the states were prepared to litigate the issue. (Such "unprotected activities" include training of customer personnel in the use of the purchased product and picking up unwanted or damaged goods.)[31]

Now, however, the new 21 day safe harbor in H.R. 1956 would significantly broaden the number of corporations protected from taxation by P.L. 86-272; it would enable corporations to engage in *both* "solicitation" and other activities *not* protected by P.L. 86-272, so long as the two activities did not require the seller's employees to be in the state for more than 21 days combined. If H.R. 1956 were enacted, for example,

- A book publisher whose titles are sold by a particular bookstore chain could visit the chain's headquarters and individual stores in each state six times per year to take orders. As a result of the new 21 day safe harbor, the publisher also could send employees into the states to oversee book signings at retail bookstores on an additional 15 days per year without becoming subject to the states' corporate income taxes.

- A fast-food franchisor could hold two meetings per year in a state to try to sell new franchises. The new 21 day physical presence safe harbor would also enable the franchisor to send employees into the state for an additional 19 days per year to inspect existing franchisees for quality-control purposes without becoming subject to the state's corporate income tax.

- A New York advertising agency could visit a potential corporate client in Connecticut for three days to "pitch" and negotiate a contract for development of an ad campaign. As a result of the new 21 day safe harbor, the agency now could also send an unlimited number of its employees into Connecticut for an additional 19 days within the same year to shoot the commercials, show them to the client, and engage in any other type of activities it wished to.

Circumventing the 21-Day Limit

In addition to enabling corporations protected by P.L. 86-272 to engage in additional "unprotected," post-sale activities in a state without triggering nexus, the 21 day physical presence safe harbor in H.R. 1956 effectively would allow many large corporations to have an *unlimited* amount of equipment and employees in a state at all times so long as the corporation did not maintain a permanent facility in the state. The key to this possibility is the fact that the 21 day physical presence "safe harbor" applies to each individual corporation as a legal entity, including corporations that are subsidiaries of other corporations.

- Take, for example, a company that maintains a pool of employees that travel to its customers' place of business to maintain and repair computers. Since a year may be divided into approximately 18 periods of 21 days each, this company could incorporate 18 subsidiaries to employ its repair personnel and rotate which subsidiary was assigned to handle repair requests in a particular state in each 21-day period. If no individual subsidiary sent employees into a particular state for more than 21 days in a given year, BAT nexus would not be created for any of the subsidiaries. In short, the business would be taxable in only its home state despite the more-or-less permanent presence of its employees in its customers' states.

- Of course, any company that needed to have an intermittent (as opposed to a continuous) physical presence in a state but wanted to avoid nexus there could do so using fewer than 18 subsidiaries. For example, a movie studio that needed to shoot two different movies on location in a particular state for 15 days each in a particular year could separately incorporate the two productions; indeed, that would likely be done for non-tax reasons anyway. When the movies were completed, the subsidiaries would be liquidated or merged back into the parent.

Corporations Already Go to Great Lengths to Shelter Their Profits from Taxation

There is nothing far-fetched about the scenarios just described. If the potential tax savings from avoiding nexus in a particular state were sufficiently large, corporations would willingly incur the legal and accounting expenses entailed in implementing these strategies.[32] Corporations already go to great lengths to shelter their profits from state and federal taxation:

- Thousands of corporations have been willing to incur 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.[33]

- Over 1,300 corporations, including Dell Computer and "Baby Bell" company SBC Communications, have completely restructured their Texas operations into limited partnerships in order to take advantage of a self-imposed nexus limitation on out-of-state corporate partners enacted by Texas more than ten years ago.[34]

- A number of states and the U.S. General Accounting Office have documented a widespread corporate practice of "SUTA dumping." This is a tax-avoidance strategy used by corporations that tend to have high employee turnover and therefore are subject to high state unemployment tax rates. In one common form of SUTA dumping, corporations form new subsidiaries and transfer their employees to these subsidiaries to take advantage of lower unemployment tax rates for which new corporations typically are eligible. GAO documented that this strategy has been widely marketed by certain accounting and consulting firms, which apparently believe that the practice is a legal technique for minimizing state unemployment taxes.[35] A more recent article reported that the major accounting firms Deloitte & Touche and Pricewaterhouse Coopers were among those involved in setting up such tax shelters, charging $300,000-$400,000 for their services.[36] Congress itself recognized "SUTA dumping" as an abusive tax shelter and recently enacted legislation that bans it.[37]

- Corporations routinely create subsidiaries whose in-state activities are limited to soliciting sales in order to isolate activities that require physical presence in a state from the portion of the corporation that can be immunized from taxation by P.L. 86-272.[38]

- Investigations into federal tax shelters have demonstrated that corporations will incur substantial out-of-pocket costs to shelter profits from taxes. For example, for tax benefits alone, major corporations have laid out hundreds of millions of

> dollars to buy life insurance policies on millions of employees and tracked the deaths of those individuals long after they have left the employ of the companies. Life insurance-related tax shelters have been so lucrative for corporations that they have continued to pursue them despite repeated congressional crackdowns.[39]

In short, the 21-day safe harbor for temporary physical presence in a state contained in H.R. 1956 would allow many sophisticated multistate corporations to avoid having a business activity tax liability to all states in which they had customers except those in which they were headquartered or had some other type of permanent physical facility.[40] Substantial numbers of employees and substantial amounts of equipment could be maintained in states by such companies on a continuously rotating basis without creating BAT nexus. Of course, this belies the proponents' fundamental rationale for the legislation:

> Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens — economic as well as administrative — only on businesses that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means if a business is not physically present in a jurisdiction, it is *therefore* not receiving *any* benefits or protections from the jurisdiction, and it should not be required to pay tax to that jurisdiction.[41]

Clearly, a corporation that continuously maintains personnel and property in a state is, at the very least, receiving substantial police and fire protection from that state — whether or not it maintains a "brick and mortar" facility there.

Blocking States from Asserting a Corporation Has "Attributional Nexus" in the State

In its 1987 *Tyler Pipe* decision, the U.S. Supreme 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 in-state business 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." In an earlier (sales tax) nexus case, the Court had recognized that to allow a corporation to avoid creating nexus in a state simply by using "independent contractors" rather than its own employees to solicit business on its behalf "would open the gates to a stampede of tax avoidance."[42]

When, under the authority of these decisions, states impose a tax on an out-of-state corporation based on in-state activities conducted on its behalf by another business, this is often referred to as "attributional nexus." If states did not have the authority to establish nexus over an out-of-state corporation on an "attributional" basis, corporations would have virtual free reign to avoid nexus in every state except the one in which they are headquartered. This is because it is possible for a corporation to carry out almost any business function by contracting with an individual, an unrelated business, or a subsidiary to perform the function rather than having it done by its own employees using its own property.

H.R. 1956 contains three new safe harbors against the creation of attributional nexus that would, as the Supreme Court recognized, facilitate massive tax avoidance by corporations — above and beyond that resulting from the bill's other provisions.

First, H.R. 1956 allows an in-state business to conduct *any* activity on behalf an out-of-state corporation in a state for 21 days per year without creating BAT nexus for the latter. Since *Tyler Pipe* clearly established that hiring a business in a state to engage in activities that help "establish and maintain a market" for the out-of-state company creates BAT nexus for the out-of-state company, and since no court decision suggests that such activities must be conducted for a minimum number of days, this provision of H.R. 1956 inherently creates a new nexus safe harbor.[43]

Agents Not Involved in Selling Don't Establish Nexus

Second, H.R. 1956 provides that the *only* activities that create nexus in a state for an out-of-state corporation when they are conducted within the state by another party acting on its behalf are those that "establish or maintain the market in that State." In other words, contracting with another party to conduct activities *not* related to selling or interacting with customers would *never* be nexus-creating if H.R. 1956 were enacted. While it is not entirely clear when non-customer-related activities performed by another party would create BAT nexus under current law, most experts likely would agree that if the contract made the second party the actual legal *agent* of the company contracting for its services, such a contract *would* be nexus-creating. Examples of such an "agency relationship" under current law include the following scenarios:

- A manufacturing corporation establishes a subsidiary whose function is to purchase on its behalf all the inputs into its manufacturing process.[44] The subsidiary recruits and hires employees, contracts for the corporation's health and workers' compensation insurance, and buys raw materials and equipment. The subsidiary has employees engaged in these activities in numerous states throughout the year. The subsidiary has the authority to hire the employees and to sign contracts binding the parent to purchase insurance, raw materials, and equipment under the negotiated terms of the contracts. Under this scenario, the presence of the purchasing subsidiary's employees in a state would likely be sufficient to create BAT nexus for the parent in such state.

- A California manufacturer hires a second, 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 subcomponent of the California manufacturer's products. The Oregon quality-control business has the authority to sign-off that the subcomponents meet the necessary specifications of the California manufacturer 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.

If H.R. 1956 were enacted, however, nexus would no longer be created for the out-of-state manufacturers under either of these scenarios, because the activities conducted by the purchasing subsidiary and 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 H.R. 1956 — even where the very same activities would be nexus-creating if conducted by the corporation's own employees.

The "Two Business Entities" Loophole

The third attributional nexus-related provision of H.R. 1956 is the most far-reaching one and the one likely to do the most damage to state and local BAT revenues. The bill decrees that a state may not subject an out-of-state corporation to a BAT on the basis of in-state activities conducted on its behalf by another business so long as the in-state business "performs similar functions on behalf of at least one additional business entity during the taxable year." This ban on the assertion of attributional nexus applies even to activities aimed at "establishing and maintaining the market in the State" for sales by the out-of-state company.

The enormous potential impact of this safe harbor arises from the fact that it applies even if all of the parties are related. It effectively enables corporations selling goods and services to have their own employees engage in *any* activities in a state that help to facilitate such sales without creating nexus for the selling corporation. All the corporation needs to do is organize itself into at least three legal entities: one corporation that employees the workers conducting the "market establishing and maintaining" activities in the state in which the corporation wishes to avoid nexus, and at least two out-of-state subsidiary corporations that are the nominal "sellers" of the goods or services to the customers. To satisfy the latter condition, the corporation could form two subsidiaries to sell two different groupings of its product lines. The following are examples of tax-avoidance or tax-minimization opportunities that would be created by this provision of H.R. 1956:

- To maximize its ability to make sales throughout the United States, a Texas-based manufacturer of personal and network server computers needs to have the capability both to provide on-site warranty repair service of the computers it sells and to set up "local area networks" of those computers for its customers. It wishes to have its own employees perform these functions both to maximize its control over the quality of the work and because it does not wish to share the profits from the networking services with independent subcontractors who could be hired to provide them. The corporation is especially anxious to avoid establishing BAT nexus outside of Texas because Texas' method of taxing the profits of multistate corporations ensures that none of the profit the corporation realizes on the actual sale of the computer equipment to non-Texas customers will be taxed in Texas if it is not taxed anywhere else.

  If H.R. 1956 were enacted, this corporation could easily ensure that the profit it realizes on the sale of the computer hardware itself would not be taxable outside Texas (and therefore anywhere). The corporation could reorganize itself into three legal entities: one to employ the staff who provide on-site warranty repair and networking services, one to sell desktop computers, and one to sell server computers. The performance of the on-site repair and networking services in the customers' states, even if done by a subsidiary, would ordinarily establish BAT nexus for the subsidiaries selling the computers, since it contributes to the "establishment and maintenance" of the in-state market for sales of the computers. (States could document that customers would buy fewer computers from the Texas company if they were not assured that needed warranty repairs would be done on-site.) However, since the in-state warranty repair/networking subsidiary provides these services to more than one "business entity", that is, to both the subsidiary that sells desktop computers and the subsidiary that sells servers, under H.R. 1956 those activities no longer create BAT nexus outside of Texas for the Texas computer manufacturer.

- An increasing number of retail store chains are becoming so-called "bricks and clicks" businesses, that is, they are setting up subsidiaries to sell the same merchandise over the Internet. These businesses are also increasingly looking for ways that they can integrate the operations so that the stores facilitate greater purchases from the Web site (and vice-versa). Such strategies include accepting returns in the stores of unwanted merchandise purchased at the Web site, selling gift cards in the stores that can be redeemed at the Web site, allowing in-store pick-up of items purchased on the Web site, placing kiosks in the stores that can immediately be used to place orders at the Web site for merchandise that is not in-stock in the stores, and advertising the Internet address of the Web site in all the stores' advertising.[45] Most of these kinds of in-state activities conducted by the stores to enhance the sales of the Web sites go beyond the "solicitation" protected by Public Law 86-272. Moreover, under the Supreme Court's *Tyler Pipe* decision, the activities create BAT nexus for the Web subsidiary because they are "significantly associated with the [Web subsidiary] taxpayer's ability to establish and maintain a market in . . . [the] State[s where the stores are located] for [the Web subsidiary's] sales."

  Under H.R. 1956, however, the retail chain could easily ensure that the activities conducted by the stores and their employees to enhance purchasing from the Web site would not create BAT nexus for the Web site in the states in which the stores are located.[46] As in the previous example, all that the company needs to do is split the Web operation into two separate corporations and have each one be the nominal, legal seller of a portion of the company's product lines to final consumers.[47] Under such a structure, the stores would be conducting activities that help "establish and maintain the market in [the] state for more than one "business entity," thereby bringing themselves under the requirements of this nexus safe harbor in H.R. 1956. The two Web subsidiaries would remain free to contract with each other to share a common Web site, warehouses, and other operational requirements; in other words, taking advantage of this tax-avoidance opportunity would not entail significant out-of-pocket expenditures beyond some legal and accounting costs. As noted above, corporations have long routinely subdivided their operations to take advantage of Public Law 86-272 alone; H.R. 1956 provides them with numerous additional tax minimization opportunities if they do so.

Of course, the "two business entities" provision of H.R. 1956 also enables 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. For example:

- Under electrical utility deregulation implemented in some states, electricity consumers are free to contract for their electricity with independent power producers that own their own generating plants but not the distribution lines that actually enter customers' homes and businesses. The power generators are often outside the state(s) where their customers are located. The power producers must contract with the local utility that owns the distribution lines to deliver the electricity, read the customers' meters, and bill the customers. These activities performed by the local utility are critical to the ability of the out-of-state power generator to "establish and maintain a market" in its customers' state(s), and are therefore nexus-creating for the generator. However, if H.R. 1956 were enacted, the out-of-state power generators would no longer have BAT nexus in their customers' state(s) because the local utilities typically deliver power for more than one "business entity," that is, more than one independent generator. Even if a local utility delivered power for only a single independent generator, however, the latter could easily avoid nexus by dividing itself into two legal entities, for example, a subsidiary that sold power to business customers and a subsidiary that sold power to residential customers.

In sum, the attributional nexus-related language of H.R. 1956 effectively overrules the Supreme Court's *Tyler Pipe* decision and substantially broadens the nexus protections provided by Public Law 86-272. *Tyler Pipe* decreed that a corporation would have BAT nexus in any state in which it hired another business or individual to conduct activities on its behalf that were "significantly associated" with the corporation's ability to "establish and maintain" a market for its wares; under H.R. 1956, all the corporation needs to do to get around this holding is to make sure its wares are sold by at least two subsidiaries. Similarly, P.L. 86-272 provides that in-state "solicitation of orders" is the *only* activity that may be conducted "on behalf" of an out-of-state corporation by an in-state business without establishing income tax nexus for the out-of-state corporation; under H.R. 1956, *any* activities may be conducted in a state "on behalf" of an out-of-state corporation without establishing income tax nexus for the latter as long as "similar functions" are conducted "on behalf" of one other corporate subsidiary.[48]

Activity-specific Safe Harbors from Nexus

H.R. 1956 also contains a number of what might be called "activity specific" nexus safe harbors. These provide that the in-state presence of employees and/or property does not establish BAT nexus if the employees are engaged in or the property is used for certain enumerated activities — even if both employees and property are present in the state for more than 21 days in a tax year.

Probably the most far-reaching of these activity-specific safe harbors is one that says that the in-state presence of equipment ("tangible personal property") owned or rented by an out-of-state corporation does not establish BAT nexus for the latter if it is being "used to furnish a service to the owner or lessee by another person." The following two examples illustrate how such a safe harbor could function to prevent the creation of BAT nexus by an out-of-state company and reduce its corporate income tax liability:

- A national Internet service provider like American Online has "local points of presence" (POPs) in thousands of communities across the United States. These are banks of modems, Internet routers, and related computer equipment that enable dial-up customers to connect to AOL's Virginia-based Web site without incurring the cost of a long-distance telephone call. If AOL itself owns this equipment, it creates BAT nexus in the states in which the POP is located. If a separate corporation (either an AOL subsidiary or an independent company) owns the equipment and leases it to AOL, states could still take the position that the activity is "significantly associated" with the ability of AOL to "establish and maintain a market" for its Internet access service in its customers' states and therefore still creates nexus for AOL.[49] If H.R. 1956 were enacted, however, AOL could retain ownership of this equipment yet allow it be used and maintained by a subsidiary or independent company to "furnish a service to the owner," that, is "local customer connectivity" services to AOL. AOL would not have BAT nexus outside Virginia despite having millions of dollars worth of property in other states. The ownership of most of the POP equipment does not increase AOL's corporate tax liability to Virginia, because most of it is not located in Virginia. (Like the large majority of states with corporate income taxes, Virginia determines the share of a corporation's nationwide profit taxable in Virginia by averaging the shares of the corporation's nationwide payroll, property, and sales located within its borders.) The existence of substantial AOL-owned property in a state in which AOL is not taxable creates substantial "nowhere income" — profit that is not taxed by any state.[50]

- A computer chip manufacturer owns several multi-billion dollar fabricating plants around the country. A substantial share of the value of the plants is in the chip-making equipment, which is considered "tangible personal property" rather than real estate. If H.R. 1956 were enacted, the manufacturer could form separate subsidiaries to own and operate each of those plants and pay the subsidiaries a service fee for its "contract manufacturing" services to the parent. However, the parent corporation would retain ownership of the chip-making equipment itself. As in the previous example, the presence of substantial property owned by the parent in a state in which the parent is not taxable would create "nowhere income" — profit that would go completely untaxed.

Finally, H.R. 1956 allows a business to have an unlimited amount of property and employees present in a state for an unlimited number of days in a tax year without creating BAT nexus, if they are engaged in several specified activities. Four of the six activities are significant safe harbors that likely would provide substantial tax benefits to a large number of corporations. Under H.R. 1956 nexus is not created by the presence of employees or property in a state in connection with:

- the "possible purchase of goods or services for the business;"[51]
- "gathering news and covering events for print, broadcast, or other distribution through the media;"
- "participation in educational or training conferences, seminars or other similar functions;"[52] and
- the assembling, manufacturing, processing, or testing of the property on behalf of its out-of-state owner.

These four safe harbors are likely to allow numerous corporations to have a substantial amount of property and a large number of employees in a state for an extended period of time yet remain exempt from the state's corporate income tax or other BAT. With respect to the fourth safe harbor, for example, it is quite common for businesses to retain ownership of valuable raw materials or partially-manufactured products while they are being further processed or assembled by another business in another state. Yet no amount of in-state property would be nexus-creating for the owner under this scenario, despite the police and fire protection provided to the property while it is in the state.

Similarly, covering a major sporting event like the Superbowl or the Olympics may require a TV network to have dozens or hundreds of employees and millions of dollars of equipment in a state for weeks or months. Yet despite the substantial state and local governmental services provided to those employees and property items, the network would not be subject to BAT in the state.

Moreover, H.R. 1956 states that the ownership or renting of real property that is "used ancillary" to these four activities does not establish BAT nexus. That suggests that a manufacturer could maintain a permanent purchasing office in a state, a TV network could maintain a permanent news bureau in a state, and any corporation could maintain a permanent employee training facility in a state without creating BAT nexus.[53]

It should be apparent from this Appendix that enactment of H.R. 1956 would have a far-reaching impact on the ability of state and localities to impose corporate profits taxes and other BATs on many out-of-state corporations that they currently have the authority to tax because the businesses have a substantial physical presence within their borders. The body of this report provides some additional examples of the corporate tax avoidance possibilities that enactment of this proposed legislation would open up.

Notes

[26] "Taxing authority of a state" is not defined in H.R. 1956, but the reference appears in a section of the bill titled "Jurisdictional standard for state and local net income taxes and other business activity taxes." Presumably, therefore, the entire section is intended to apply to local BATs as well as state BATs. Neither is the word "person" defined in H.R. 1956. Presumably it is intended to apply to all business entities (including corporations, limited liability companies, trusts, and partnerships) in addition to "natural persons" or individuals.

[27] Like H.R. 1956 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 the most significant impact of the legislation in revenue terms is associated with corporate tax payments, the discussion in this report generally refers to corporate income or profits taxes.

[28] A company-owned office, even if used just for solicitation of orders, is not protected by Public Law 86-272, and so a state is free to impose a corporate income tax on an out-of-state corporation with such an office within its borders. See Notes 29 and 53.

[29] 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. Interestingly, the Court implied that it would have interpreted P.L. 86-272 as protecting the in-state presence of a permanent sales office as well but for other language in the law that specifically sanctioned an in-state sales office owned by an independent contractor soliciting sales on behalf of an out-of-state company.

[30] These loan officers arguably 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 possible purchase of goods and services for the business also does not constitute a "physical presence." Deposits could be characterized as intangible goods or services purchased by banks through the payment of interest.

[31] See: Multistate Tax Commission, "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272" (1986). Available at www.mtc.gov/UNIFORM/pl86-272_72701.pdf.

[32] The corporate income tax savings from avoiding creating nexus in a state can be enormous; indeed, depending upon the specific states involved, corporations can avoid taxation of *all* of their profits. Take, for example, a Connecticut manufacturer, all of whose customers are in Massachusetts. If the corporation can avoid creating nexus in Massachusetts, none of its profit will be taxable in either Connecticut or Massachusetts. If it establishes nexus in Massachusetts, its entire profit would be taxed in that state. See: Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?*, Center on Budget and Policy Priorities, revised May 2005, pp. 11-13 (discussing the tax consequences of the interaction of a single sales factor state corporate income tax apportionment formula and the absence of the "throwback rule").

[33] *Secretary of Revenue of North Carolina* v. *A&F Trademark, Inc., et al*., North Carolina Tax Review Board, May 7, 2002. For a discussion of how widespread the use of intangible holding companies appears to be, see: Michael Mazerov, *Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States*, Center on Budget and Policy Priorities, revised May 21, 2003. Available at www.cbpp.org/4-9-02sfp.pdf. This report notes that the decision in the North Carolina *Limited* case revealed that this corporate group sheltered over $1 billion in profits fromstate taxation in a three-year period through the use of intangible holding companies.

[34] 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, CRAFT questioned the relevance of this Texas experience to BAT nexus legislation, since the legislation itself would not prevent 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 H.R. 1956 would create numerous such opportunities.

[35] 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.

[36] "State Releases Names of Firms that Avoided Unemployment Taxes," Associated Press story, July 9, 2004.

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

[38] Splitting a corporation into multiple subsidiaries to take advantage of the safe harbor for "solicitation" created by Public Law 86-272 might be characterized as "State Tax Planning 101." In its section titled, "Basic Multistate Tax Planning," a major reference source on multistate corporate taxation observes: "When a corporation has only a limited connection with a state, it may be possible to discontinue that activity by using an alternative means of accomplishing the same result. . . . When nexus is created by sales representatives performing repair and maintenance services in the state, one strategy would be to separately incorporate the sales division that operates in the state." See the source cited in Note 9.

[39] Ellen E. Schultz and Theo Francis, "How Life Insurance Morphed into a Corporate Finance Tool," *Wall Street Journal*, December 30, 2002.

[40] As will be discussed below, one provision of H.R. 1956 arguably *would* allow certain businesses to have permanent physical facilities in many states without creating BAT nexus in such states. See Note 53.

[41] Letter from the Council on State Taxation to members of the U.S. House of Representatives in support of H.R. 2526, July 16, 2002. Emphasis added. H.R. 2526 was the version of BAT nexus legislation introduced in the 107th Congress.

[42] *Scripto* v. *Carson*, 1960.

[43] Admittedly, this provision is consistent with the other provisions of H.R. 1956. It would be illogical to allow a company to have its own employees and property in a state for up to 21 days for any purpose without creating nexus and yet not grant the same safe harbor to third parties engaging in the same activities on behalf of the same company.

[44] Such a subsidiary is sometimes termed a "captive procurement entity." See: R. Scot Grierson, "Related-party Transactions," *State Tax Notes*, December 6, 2004, pp. 659-660.

[45] See: Kortney String, "Shoppers Who Blend Store, Catalog and Web Spend More," *Wall Street Journal*, September 3, 2004.

[46] Again, there are a number of reasons why the corporation may wish to minimize the number of states in which the Web operation is subject to a corporate income tax or other BAT. In particular, the states in which the Web subsidiaries are located may have in place a combination of tax rules (a "super-weighted" sales factor and the absence of a "throwback" rule) that ensures that a substantial portion of any profits realized by the Web operation from selling in other states is not taxed by *any* state. (See the sources cited in Notes 5 and 32.) As was discussed in the body of the report, even if the all of the profits of the Web operation are taxable in the state(s) where it is located and the company obtains only a modest net tax savings from the restructuring described in the example, it remains the case that H.R. 1956 would block the ability of the states where the stores are located to tax their fair share of the profit of the Web site.

[47] Again, there is nothing far-fetched about this scenario; in fact, it is in widespread use today. For example, Amazon.com operates the entire online operation of a number of retail store chains, including Borders Books. Yet

Borders is the nominal seller of items purchased from www.borders.com; this arrangement is apparently aimed — at least in part — at ensuring that Amazon does not establish nexus in states in which Borders stores are located.

48 It should also be noted that the "attributional nexus" provision of H.R. 1956 under discussion here would provide another way around the language of the bill that provides that BAT nexus *is* created for a corporation if its own employees and property are present in a state for more than 21 days (assuming state law so-provides). As discussed above, any corporation that wished to have employees in a state for more than 21 days could incorporate multiple subsidiaries to employ those workers (and, as also explained, the incorporation of 18 subsidiaries would allow year-round presence of employees without creating BAT nexus.) Alternatively, a corporation that wished to have employees permanently in a state for any purpose need only incorporate one subsidiary to employ them, again, so long as this subsidiary did the work for at least two other commonly owned entities. Thus, in the earlier example of the computer repair business (see p. 6), the business could avoid BAT nexus in all the states in which the repairs are conducted (except its headquarters state) by forming one subsidiary to employ the repair workers. This subsidiary is a subcontractor to two other subsidiaries that actually contract with final customers for the repair work — one subsidiary contracting with customers in states A, B, and C, and the other subsidiary contracting with customers in states D, E, and F. Since the subsidiary whose employees actually perform the repairs in the states is nominally doing so "on behalf" of two separate corporations, the presence of the repair people in the states does not establish nexus for the corporation on whose behalf they are working.

49 At least two states, Tennessee and Connecticut, have taken AOL to court claiming that its local points of presence within their borders establish sales tax and/or BAT nexus. The Tennessee case is still pending.

50 Just as they have with respect to sales occurring in a state in which the corporation is not taxable, states could in theory enact a property "throwback rule" that would assign the property for tax purposes to the headquarters state to nullify the creation of "nowhere income." However, corporations have succeeded in blocking roughly half the states from enacting the sales throwback rule, including stopping several concerted state legislative efforts in the past couple of years. Enactment of a property throwback rule would be unprecedented and, in a number of states, would require a supermajority of the legislature or a statewide referendum

51 It is difficult to interpret the import of the word "possible" in this provision of H.R. 1956. It might be intended to mean that if an employee present in a state for more than 21 days actually purchased a good or service for her out-of-state employer, it would create BAT nexus for the latter. If that is the intention, it could probably easily be circumvented by ensuring that the contract for the purchase was executed at the company's out-of-state headquarters. However, a section-by-section analysis of H.R. 3220 — the predecessor to H.R. 1956 — on the Web site of the lead sponsor, Representative Bob Goodlatte, contains a blanket statement that implies that actual purchasing of inputs is non-nexus-creating: "The following activities are exempted from the 21-day rule, such that businesses could assign employees in a State for an unlimited period of time and not be taxed if the activities are any of the following: Purchasing goods or services for the employer. . ."

52 Note that this wording does not limit such participation to that of a "trainee;" it encompasses the trainer as well. Nor is it restricted to such events organized by independent companies or organizations. Accordingly, the language allows a corporation to conduct unlimited training of its own employees, customers, or potential customers in a state without creating BAT nexus — including training held at a company-owned facility (see Note 53). It would also seemingly immunize from taxation the numerous for-profit companies that travel around the country providing educational seminars, for example, sessions on retirement planning.

53 The Coalition for Rational and Fair Taxation has disputed that the wording of these safe harbors allows the ownership or renting of brick-and-mortar facilities in which these activities are carried out. Citing the 1992 decision in *Wrigley* v. *Wisconsin* interpreting the scope of protected "solicitation" in Public Law 86-272, CRAFT has stated: "There is no basis for this concern. The U.S. Supreme Court has held that the ownership of real property, whether a sales office or facility, is not a protected activity." In *Wrigley*, however, the Court was interpreting the wording of P.L. 86-272 alone. Moreover, the Court implied that it might have interpreted protected "solicitation" as encompassing ownership of an office limited to that function but for an explicit granting of authority to own an office to independent contractors representing out-of-state sellers but not to the sellers themselves.

In any case, the *Wrigley* Court interpreted the totality of P.L. 86-272 as indicating Congress' "judgment that a company office within a State is such a significant manifestation of company 'presence' that, *absent a specific exemption*, income taxation [of the owner of the office] should always be allowed." [Emphasis added.] But H.R. 1956 *does* provide for a specific exemption; it states explicitly that "the leasing or owning of tangible personal property or real property in [a] state on more than 21 days" does not create nexus if it is "used ancillary to an activity" excluded from the 21 day limit, such as news gathering. In short, there is good reason to interpret H.R. 1956 as providing a nexus safe harbor even for the ownership of an office for news gathering, purchasing of inputs, or training company employees. This is an issue around which considerable litigation is likely to occur if H.R. 1956 is enacted.