
Revised November 30, 2005

FEDERAL “BUSINESS ACTIVITY TAX NEXUS” LEGISLATION: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes By Michael Mazerov

Background and Summary

Major multistate corporations are engaged in a two-pronged strategy aimed at substantially increasing the share of their nationwide profit that is not taxed by any state. The strategy involves the enactment of complementary state and federal legislation. The state legislation — which corporations have already succeeded in enacting in 14 states and are actively seeking in close to a dozen more — is aimed at lowering the corporate taxes of in-state corporations and shifting these taxes onto out-of-state corporations. The federal legislation, which corporations have been seeking since 2000, would make it much more difficult for states to require many out-of-state corporations to pay *any* income tax. Together, the two changes in tax law would create a “heads I win, tails you lose” system of state corporate income taxation — with corporations the winners and state treasuries the losers.

The latest version of the federal legislation is H.R. 1956, the “Business Activity Tax Simplification Act of 2005.” Its lead sponsors are representatives Bob Goodlatte and Rick Boucher. Like its predecessors, H.R. 1956 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 collected by 45 states and the District of Columbia are the most widely-levied state business activity taxes and are the focus of this report. (The term also encompasses such broad-based business taxes as the Michigan Single Business Tax — a form of value-added tax — and the Washington Business and Occupations Tax — a state tax on a business’ 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 laws levying a tax on a business will set forth the types of activities conducted by a business within the state that obligate the business to pay some tax (which usually is proportional to the level of activity in the state). 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 pay the tax. Federal statutes can override state nexus laws, however, and H.R. 1956 proposes to do so in four key ways:

- H.R. 1956 declares that a business must have a “physical presence” within a state before that jurisdiction may impose a BAT on the business. This provision would nullify many state laws that assert that a non-physically-present business establishes nexus with the state when it makes economically-significant sales to the state’s resident individuals and/or businesses. In establishing this true, “physical presence” nexus threshold, H.R. 1956 would resolve in favor of business a lingering question as to whether state laws declaring nexus to be created by sales alone are valid under the U.S. Constitution.
- Under H.R. 1956, however, some businesses could have a physical presence in a state *without* creating nexus. The bill would create a number of nexus “safe harbors.” These are categories and quantities of clear physical presence that a corporation or other business could have in a state that nonetheless would be deemed no longer sufficient to create BAT nexus for the business. For example, the bill allows a corporation to have an unlimited amount of employees and property in a state without creating nexus, so long as neither are present in the state on more than 21 days within a particular year.
- H.R. 1956 substantially expands an existing nexus “safe harbor,” federal Public Law 86-272. P.L. 86-272 provides that a corporation cannot be subjected to a state corporate income tax if its only activity within a state is “solicitation of orders” of tangible goods, followed by delivery of the goods from an out-of-state origination point. The protected “solicitation” may be conducted by advertising alone or through the use of traveling salespeople. H.R. 1956 would expand the coverage of P.L. 86-272 to the entire service sector of the economy and apply it to all types of BATs, not just income taxes.
- H.R. 1956 would impose new restrictions on the ability of a state to assert BAT nexus over an out-of-state corporation based on activities conducted within its borders by a (non-employee) individual or other business acting on behalf of the out-of-state business.

In short, H.R. 1956 is intended to substantially raise the nexus threshold for corporate income taxes and other BATs — that is, to make it much more difficult for states to levy these taxes on out-of-state corporations.

The fact that state corporate income tax nexus thresholds would be raised by H.R. 1956 means that the profits of particular corporations would no longer be subject to tax in particular states. While that may raise equity concerns, it does not inherently mean that the states as a group would lose corporate income tax revenue. In fact, however, many of the same corporations pushing for the enactment of legislation like H.R. 1956 at the federal level are lobbying at the state level for complementary changes in state corporate income tax laws. These state laws *would* ensure that the enactment of legislation like H.R. 1956 would result in a substantial corporate tax revenue loss for states in the aggregate:

- Multistate corporations are lobbying in numerous states for a switch to a so-called single sales factor apportionment formula. (They have already obtained enactment of the single sales factor formula in 14 states.) Apportionment formulas embedded in each state’s corporate income tax law determine *how much* of a multistate corporation’s nationwide profit is subject to tax in a state in which it *does* have nexus. If a corporation makes 10 percent of its sales to customers in a single sales factor state, then 10 percent of its nationwide profit will be subject to tax in that state.

- Under a single sales factor formula, a corporation that produces all of its goods in a state but has all of its customers in other states will have *no* corporate income tax liability to the state in which it does its production. However, if this same corporation did not have nexus in its customers' states, because the activities it conducted in those states would be deemed no longer nexus-creating under H.R. 1956, then *all* of this corporation's profit would become "nowhere income" — profit not subject to tax by *any* state.
- In reality, of course, most corporations do have at least some customers in the states in which they produce their goods and services, and even under legislation like H.R. 1956 they would often have nexus in some of the other states in which their customers are located. So most multistate corporations would continue to pay some state corporate income taxes even if legislation like H.R. 1956 were to be enacted.
- Nonetheless, if the state corporate income tax nexus threshold were raised sharply by new federal legislation, and if multistate corporations continue to make progress in their campaign to get large industrial states to switch to a single sales factor formula, the two policies would interact in a way that would vastly expand the share of total nationwide corporate profit that escapes taxation entirely.

The creation of more "nowhere income" is a major goal of the multistate corporate community in seeking the enactment of bills like H.R. 1956, notwithstanding claims that the legislation is only intended to regulate *which* states can tax a corporation and not to affect the aggregate taxation of corporate income. The evisceration of state corporate income taxes — the source of \$28 billion in annual revenue — would harm states already struggling to provide adequate education, health, and homeland security-related services.

It is not at all clear that congressional action to clarify and harmonize state BAT nexus thresholds is warranted, but if Congress is determined to act, viable alternatives to bills like H.R. 1956 are available that would do less damage to state finances. Congress could implement a proposed model nexus threshold carefully crafted by the Multistate Tax Commission, which would base the existence of BAT nexus on relatively objective measures of the amount of a corporation's property, payroll, or sales present in a state.

Disingenuous Corporate Rhetoric

Among the many arguments proponents offer in support of BAT nexus legislation is the claim that the legislation is needed to stop states from imposing unfair corporate tax burdens on out-of-state corporations with minimal physical presence within their borders. States are accused of engaging in "taxation without representation" — targeting for excessive taxation out-of-state businesses that have little political influence in states in which they have few if any employees.¹ (See the text box on page 4 for a debunking by two leading state tax experts of the "taxation without representation" argument.)

Two Leading State Tax Experts Debunk “Taxation without Representation” Argument Offered in Support of BAT Nexus Legislation

Proponents of federal BAT nexus bills like H.R. 1956 argue that such legislation must be enacted to stop (alleged) state “taxation without representation” of out-of-state corporations. Leaving aside that such rhetoric is inconsistent with the pursuit by many of these same corporations of “single sales factor” apportionment rules (as discussed in the body of this report), the argument is dubious on its own terms. In a 2004 paper, two leading experts on state tax policy thoroughly debunked the “taxation without representation” argument:

A second invalid argument [offered in support of federal BAT nexus legislation] relies on the Revolutionary War rallying cry “no taxation without representation.” Opponents of tighter nexus rules suggest that those rules would violate the basic American principle that there should be no taxation without representation. That argument fails on several grounds. First, not all rallying cries of the Revolutionary War made their way into the Constitution. An inviolate link between the right to vote and the duty to pay tax is not among those that did. Individuals who lack the right to vote due to nonresidence are nonetheless (properly) taxable. Second, virtually all of the taxes under discussion here are (or would be, under a tighter nexus standard) paid or collected by corporations, not by individuals. Because corporations do not vote, this argument is something of a red herring. Beyond that, out-of-state taxpayers, whether actual or potential and whether corporations or individuals, have the same right to be represented by lobbyists as do in-state corporate and individual taxpayers. Indeed, corporate officials can probably do their own lobbying without running afoul of existing nexus standards, let alone sensible ones. Thus, this charge lacks substance. Third, the same argument could be made against payment of property taxes. Finally, and most fundamentally, the type of taxation that would occur under sensible nexus rules would not discriminate against out-of-state business (something the U.S. Supreme Court would not countenance). Rather, sensible nexus rules would prevent discrimination in favor of out-of-state business by subjecting them to the same rules as in-state businesses, except as required to prevent excessive complexity. Even if it were true that out-of-state businesses had no representation, it is difficult to see the harm in requiring that they pay or collect the same taxes as their in-state competitors. (With uniform taxation, in-state businesses can be expected to help protect the interests of their out-of-state competitors in the political arena, because they will pay the same taxes.)

Source: 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. 735. The article was sponsored by the National Governors’ Association. McLure is a Senior Fellow with the Hoover Institution at Stanford University and was a 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.

Charges of excessive state taxation of out-of-state companies are disingenuous in light of the fact that multistate corporations throughout the United States — including some of the same corporations that support H.R. 1956 (and/or its predecessors) — have been lobbying at the *state* level for a change in state corporate tax policy that *intentionally* targets out-of-state businesses for heavier taxation. In more than a dozen states, individual corporations and the trade associations to which they belong have lobbied recently for state adoption of a “single sales factor apportionment formula” for the state corporate income tax. This policy change is intended to shift the corporate

tax burden off of corporations that have a significant physical presence in a state and onto corporations that have relatively little physical presence there.

The apportionment formula embedded in every state's corporate income tax law determines the share of a multistate corporation's nationwide profit upon which the state imposes its tax. The *traditional* formula is written in such a way that the more property and employees a corporation has in a state — that is, the more substantial is its physical presence — the greater the share of its nationwide profit that is subject to tax in the state and therefore the greater its tax payment to that state.

The single sales factor formula is intended to reverse this policy of subjecting corporations to higher income tax burdens the greater their physical presence in a state. When a state switches to a single sales factor formula, a corporation with substantial headquarters and/or production facilities in a state but most of its sales elsewhere is likely to experience a sharp drop in its corporate income tax liability to that state. In contrast, an out-of-state corporation with corporate income tax nexus in that state, significant sales in that state, and little (if any) permanent physical presence in that state is likely to experience a sharp increase in its corporate tax payment. In fact, since the single sales factor formula bases a corporation's tax liability to a state solely on in-state sales, a corporation with no customers in the state in which it does its production would see its corporate tax liability in that state drop by 100 percent — to zero — if the state switched to a single sales factor formula.² Overall, adopting a single sales factor formula tends to automatically shift the adopting state's total corporate tax burden off of in-state corporations with substantial facilities but relatively few sales in the state and onto out-of-state corporations in the opposite situation.

In the last decade, ten states have switched from some variant of the traditional apportionment formula to a single sales factor formula.³ In every case this change was urged on the state by major multistate corporations having a substantial physical presence within its borders. Moreover, the multistate corporate community continues to seek enactment of a single sales factor formula in numerous other states, including such major manufacturing centers as Arizona, California, Indiana, New Jersey, and Pennsylvania.

Individual multistate corporations are often reluctant to publicly endorse enactment of the single sales factor formula, preferring to leave the public face of the lobbying effort to their trade associations or state chambers of commerce. A few corporations have been exposed as having lobbied for enactment of the single sales factor formula in states in which they have a substantial physical presence — and therefore would receive a tax cut — and lobbied against it in states in which they have little physical presence and therefore would experience a tax increase. By leaving the public endorsement of single sales factor legislation to their membership organizations, multistate corporations retain the flexibility to take these contrary lobbying positions without opening themselves up to criticism for their inconsistency.⁴

A small number of individual corporations that have publicly endorsed or lobbied for state adoption of a single sales factor formula in recent years can be identified, however:

- Lobbying reports filed with the Secretary of State's office in California reveal that the membership of the "Business for Economic Growth in California" coalition that has lobbied for single sales factor legislation there in recent years has included Apple Computer, Chevron, Cisco Systems, Intel, Occidental Petroleum, Oracle, Sony, Texaco, Disney, and Sun Microsystems.⁵
- In Arizona, supporters of proposed single sales factor bills included AT&T, American Express, Honeywell, Boeing, Intel, and Goodrich/Raytheon.⁶
- In Oregon, members of the Smart Growth Coalition lobbying for single sales factor legislation included Intel, Nike, Adidas, Columbia Sportswear, and Tektronix.⁷
- In Georgia, corporations lobbying for single sales factor legislation in 2005 included BellSouth, Coca-Cola, General Electric, and Georgia-Pacific.⁸

Several of these corporations that recently have supported state adoption of a single sales factor formula also support the enactment of H.R. 1956 and/or are members of organizations that supported similar BAT nexus bills introduced in earlier sessions of Congress:

- Under the umbrella of the "Coalition to Protect Interstate Commerce" (CPIC), Apple Computer, Chevron, Cisco Systems, Sony, Disney, American Express, and Nike all signed a letter dated September 26, 2005 to House Judiciary Committee Chair Jim Sensenbrenner endorsing H.R. 1956.
- Senior tax staff of American Express, Chevron, AT&T, General Electric, Coca-Cola, Bellsouth, and Cisco Systems are currently on the board of the Council on State Taxation, an organization that represents over 500 major multistate corporations on state tax policy-related issues. COST supported H.R. 3220, the version of the BAT nexus bill introduced in the 108th Congress. H.R. 3220 and H.R. 1956 are virtually identical.⁹
- American Express, Cisco, Sony, and Disney have previously been identified as members of an ad hoc coalition organized to lobby for BAT nexus legislation, the "Coalition for Rational and Fair Taxation" (CRAFT).¹⁰
- Apple, Cisco, Oracle, and Sun were members of the "Internet Tax Fairness Coalition," a defunct organization that endorsed versions of BAT nexus legislation introduced in previous sessions of Congress.¹¹

It also seems likely that many (if not all) of the corporations identified above as supporters of single sales factor legislation in California, Arizona, Georgia, and/or Oregon are members of the Business Roundtable, National Association of Manufacturers, U.S. Chamber of Commerce, or the American Electronics Association, all of which signed the joint September 26, 2005 letter to Representative Sensenbrenner supporting the enactment of H.R. 1956.

In short, even as organizations to which they belong (or have belonged) denounce the states for allegedly imposing excessive and unfair tax burdens on out-of-state corporations with little physical presence within their borders and call for the enactment of H.R. 1956 or similar legislation to put a stop to this, more than 20 major multistate corporations are known to have lobbied at the state level

for a policy that is *intended* to shift the corporate tax burden onto out-of-state corporations with relatively little physical presence within the state. In light of the fact that at least four corporations that are former or current members of CRAFT are known to have worked for the enactment of a single sales factor formula in at least one state, it is even more ironic that CRAFT's chief lobbyist has argued that federal BAT nexus legislation is needed *because* states have enacted this discriminatory formula:

If a state has . . . a single-factor apportionment formula based only on sales (which is increasingly popular among the states), in-state businesses enjoy a significant benefit over business that have little or no property or payroll in the state but that do have sales that are apportionable to the taxing state.

When [a single sales factor formula is] combined with the economic nexus standard [which asserts the existence of nexus on the basis of significant in-state sales alone], states would actually be subsidizing such incentives for in-state businesses at the expense of out-of-state businesses that do not receive the benefits and protections provided by the state. Not only does this offend the basic principle of nondiscrimination that is required by the Commerce Clause of the U.S. Constitution but, in addition, it surely is misguided tax policy to make one party that is not really "in" the jurisdiction bear the tax burden of those persons who actually receive the benefits and protections of the government services that the taxes are funding.¹²

CRAFT's lobbyist is correct; the single sales factor formula is discriminatory tax policy. In violation of the "benefits received" principle of taxation, it imposes an excessively large share of a state's corporate tax burden on corporations benefiting less from public services in the taxing state than the corporations with a substantial physical presence in the state whose tax burden the formula lightens.¹³ The solution is to solve the problem directly by discouraging states from switching to the formula or even, perhaps, banning it through federal legislation. (See the text box on page 10 for discussion of how another key argument offered by CPIC's lobbyist in support of BAT nexus legislation like H.R. 1956 is inconsistent with the pursuit at the state level of a single sales factor apportionment formula by members of his own organization.)

Rational Self-Interest: Evisceration of the State Corporate Income Tax

While it is disingenuous of business representatives to justify their support for BAT nexus legislation on the basis of alleged state discrimination against out-of-state corporations at the same time they are lobbying at the state level for precisely that discrimination, in reality they are pursuing their self-interest in a quite rational manner. Widespread enactment of a single sales factor formula at the state level and the enactment of federal BAT nexus legislation are two complementary prongs of an attack on the corporate income tax aimed at eviscerating this much-despised (by corporations) source of state revenue.

When a state decides to switch from the traditional property-payroll-sales apportionment formula to a single sales factor formula, it is choosing to relinquish its ability to obtain substantial tax payments from its in-state corporations in favor of making out-of-state corporations pay more. The switch is likely to lead to a net loss of revenue for the state even under current law; many of the out-of-state corporations with substantial sales in the state that the single sales factor formula would

ordinarily compel to pay more tax are completely exempt from tax due to the protection from establishing nexus provided by Public Law 86-272.

The enactment of a federal bill like H.R. 1956, however, would likely magnify the revenue loss from the switch to a single sales factor formula several times over.¹⁴ Due to all the new “safe harbor” provisions in H.R. 1956, an even larger group of corporations would be protected from having nexus in states in which they have relatively little physical presence but make substantial sales. For example, H.R. 1956 would expand P.L. 86-272 to cover all multistate service businesses, like banks and television networks. H.R. 1956 also would eliminate the taxability in a state of many out-of-state businesses whose presence within the state is limited to sending in employees to interact with customers on a short-term basis, such as companies that provide on-site installation and repair of the equipment they sell.¹⁵

By making it much more difficult for states to assert income tax nexus over out-of-state corporations with relatively little or only temporary physical presence within their borders, the enactment of a bill like H.R. 1956 would largely solve the paradox of corporate support for the single sales factor formula. Corporations that tend to serve regional or national markets from production locations in only a few states — such as manufacturers — are the primary beneficiaries of the single sales factor formula; the adoption of the formula generally provides tax reductions to such corporations in the states where they are headquartered and/or produce their wares. However, the very same corporations would face tax increases in the states in which they make most of their sales but do no production if those states *also* switched to the formula. The paradox of corporate support for the single sales factor formula is that the more successful corporations are at convincing the states in which they produce their goods and services that switching to the formula is good for economic development, the more likely it is that corporations based in all the other states will convince *their* state governments that they must adopt the formula for the same reason. If every state eventually switched to the single sales factor formula, corporations would lose most of their tax savings; the tax reductions in their “production states” would be substantially offset by tax increases in their “market states” (the states where their customers are located).¹⁶

The enactment of a bill like H.R. 1956, however, would transform corporate pursuit of the single sales factor formula from a potentially self-defeating strategy into a rational — indeed paramount — objective. Even as universal adoption of the formula slashed their corporate income tax liability in their production states, bills like H.R. 1956 would protect a large number of corporations from the higher tax liability they would otherwise experience in their “market states” if those states also adopted the single sales factor formula. (H.R. 1956 would render many of the corporations completely immune from income taxation in their market states.) Widespread adoption of a single sales factor apportionment formula by states levying a corporate profits tax, in combination with the enactment of a bill like H.R. 1956, would create a situation in which a substantial share of the aggregate profits of multistate corporations would be “nowhere income” — profit not subject to taxation by *any* state.¹⁷

In short, the effort by the multistate corporate community to enact federal BAT nexus legislation represents one side of a quite conscious strategy to eviscerate the state corporate income tax — with widespread or universal state adoption of the single sales factor formula constituting the other side. Corporate lobbying already has convinced nearly one-fourth of the states imposing corporate income taxes to adopt a single sales factor apportionment formula, and business organizations continue to seek enactment of the formula in nearly a dozen additional states — including such large

ones as California and Pennsylvania. In light of these widespread, intensive, high-profile efforts to enact the single sales factor formula, claims by proponents of BAT nexus legislation that the bills do “not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the correct jurisdiction” cannot be taken seriously.¹⁸

With the bulk of corporate output in the U.S. economy covered by single sales factor apportionment rules and H.R. 1956 in place, state corporate income tax receipts would drop sharply; the corporations still relegated to paying the tax would mainly be small, wholly in-state corporations.¹⁹ With those business clamoring about their unfair tax burdens relative to their out-of-state competitors, corporate tax revenues plunging, and the tax tied up in substantial litigation over the application of the numerous vaguely-defined or undefined terms in H.R. 1956, officials in many states might well decide that the revenues generated by the tax did not justify the costs, inequity, and conflict. Repeal of the corporate income tax in many states would be a distinct possibility — likely fueling repeal in other states due to economic competitiveness concerns. While such a scenario might not displease many corporate proponents of H.R. 1956, it would do considerable damage to state and local governments and the people who depend on them for education, health care, protection from crime, and scores of other essential services; the corporate income tax generated \$31 billion in revenue in FY04.

Reasonable Alternatives to H.R. 1956 Are Available

It is debatable whether there is any need for a new federal BAT nexus law. Business activity taxes have been in place for over 50 years in most states, and multistate corporations seem to have managed to figure out in which states they are subject to them and in which states they are exempt. Despite claims by H.R. 1956 proponents that states are engaged in aggressive new efforts to assert nexus over out-of-state corporations, the vast majority of the disputes involve a single, highly abusive tax shelter employed by multistate corporations that states are justified in shutting down using every legal means at their disposal.²⁰ Even if Congress does decide it should enact new BAT nexus legislation under its authority to regulate interstate commerce, rational and fair alternatives to bills like H.R. 1956 are available. Congress could implement a proposed model nexus threshold carefully crafted by the Multistate Tax Commission, which would base the existence of nexus on relatively-objective measures of the amount of a corporation’s property, payroll, or sales present in a state.²¹ At a time when there is strong bipartisan support in Congress for shutting down tax shelters and closing loopholes that afflict the *federal* corporate income tax, it would be unfortunate and ironic if Congress enacted legislation like H.R. 1956 that would severely undermine the same — and equally-critical — source of revenue for states.

Another CRAFT Argument in Favor of Federal Nexus Legislation Is Inconsistent with Its Members' Support for the Single Sales Factor Formula

In congressional testimony in support of federal BAT nexus legislation last year, the chief lobbyist for the “Coalition for Rational and Fair Taxation” (CRAFT) stated that the legislation was needed to outlaw state efforts to assert nexus over corporations that only made sales within their borders but had no other physical presence there. He claimed that such an “economic presence” nexus threshold was inconsistent with how and where corporations earn profits:

The bottom line is that businesses should pay tax where they earn income. It may be true, as certain state tax collectors assert, that without sales there can be no income. While this may make for a nice sound bite, it simply is not relevant. Income is earned where an individual or business entity employs its labor and capital, i.e., where he, she or it actually performs work. . . . [T]here is absolutely no reason why the buyer's state should be able to impose tax on the individual selling the item — the individual earned the income in his or her home state.

In making this argument, CRAFT's lobbyist is taking issue not with a “nice sound bite” from state tax officials, but rather with a nearly 50 year-old agreement between those officials and the business community itself. In 1957, a joint state-business effort to develop uniform rules for determining where corporate profits are earned for state income tax purposes came to fruition in the promulgation of the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA was designed to assign taxable income to states in reasonable and fair relation to the activities that businesses conduct in states that generate the income. UDITPA's framers decided that making sales should be included as one of those activities, in addition to investing capital and employing labor. This acknowledged that fulfilling buyer demand does make an essential contribution to the earning of income — a fact obvious to anyone who has observed that the sale of two virtually identical shirts will generate vastly different amounts of profit depending on the presence or absence of a particular company logo prized by brand-conscious consumers.

As originally developed and implemented in most states, UDITPA assigned a one-third weight in the apportionment formula to each of the three “factors” — property, payroll, and sales. This acknowledged that the two production-related activities (investing in capital and employing labor) should play a greater role than making sales in determining which state(s) get to tax which portion of a particular corporation's profit.

The original UDITPA agreement on the relative significance of sales in the geographic assignment of taxable profits *has* substantially broken down during the last decade — but not at all in the direction suggested by CRAFT's lobbyist. The logical implication of his assertion that “Income is earned where an individual or business entity employs its labor and capital, i.e., where he, she or it actually performs work” is that the weight of the sales factor in the apportionment formula should be reduced, or indeed that the *sales factor* should be eliminated entirely. But as discussed in the body of this report, the trend has been in exactly the opposite direction. The vast majority of states have increased the weight of sales in the formula beyond the one-third weight in the original UDITPA, with nearly a dozen eliminating the *property and payroll factors* entirely. That trend has been driven by the lobbying of multistate corporations, including several of CRAFT's (present or former) members. In light of these widespread lobbying efforts in favor of greater weighting of the sales factor in state apportionment formulas, it is hard to take seriously the suggestion of CRAFT's spokesman that bills like H.R. 1956 represent a principled attempt to ensure that corporate profits can be taxed only where they are actually earned — i.e., where “a business entity employs its labor and capital.”

Notes

¹ “Unfortunately, some state revenue departments have been creating barriers to interstate commerce by aggressively attempting to impose direct taxes on businesses located in other states that have little or no connection to their states. . . Such behavior is entirely logical on the part of the taxing state because it has every incentive to try collecting as much revenue as possible from businesses that play no part in the taxing state’s society. But this country has long stood against such *taxation without representation*.” Testimony by Arthur R. Rosen, representing the Coalition for Rational and Fair Taxation, in support of H.R. 3220, before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004. Emphasis added. H.R. 3220 was the version of BAT nexus legislation introduced in the 108th Congress; it is virtually identical to H.R. 1956.

² For examples of how a single sales factor formula affects the calculation of state corporate income tax liability relative to the traditional formula that includes property and payroll factors, 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 September 2005.

³ Since 1994, Connecticut, Georgia, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, New York, Oregon, and Wisconsin have adopted a single sales factor formula for manufacturers only or for all corporations. (Georgia, Minnesota, New York, and Wisconsin are phasing-in the single sales factor formula.) Iowa, Missouri, Nebraska, and Texas had adopted a single sales factor formula at an earlier date.

⁴ The main justification offered by corporations for why states should switch to a single sales factor apportionment formula is that it is (allegedly) an effective incentive for economic development and job creation. If an individual corporation makes this argument in public testimony, the state adopts the formula, and the company then reduces its employment in a state (or chooses a non-single-sales factor state for a large investment), it runs the risk of public embarrassment. (For example, Black and Decker Corporation was a major proponent of Maryland’s adoption of single sales factor and subsequently closed its manufacturing plants in the state, a fact noted by a number of columnists.) A desire to avoid the potential for such embarrassment likely is another reason why relatively few individual corporations can be identified as having lobbied for adoption of single sales factor in the many states in which business interests have sought its enactment in recent years.

⁵ Form 635, “Report of Lobbying Coalition,” filed with California Secretary of State with respect to AB 1642 and SB 1014, January 31, 2002. Same form filed August 2, 2004, with respect to AB 2590.

⁶ Arizona Senate Caucus Calendar, March 16, 2004, SB 1143. Minutes of the Arizona Committee on Ways and Means, February 18, 2003, HB 2356.

⁷ Minutes of the Oregon Senate Revenue Committee hearing on HB 2558, April 9, 2001.

⁸ James Salzer, “\$1 Billion Corporate Tax Break,” *Atlanta Journal-Constitution*, March 4, 2005. Nancy Badertscher, “House OKs Business Tax Cut,” *Atlanta Journal-Constitution*, February 9, 2005.

⁹ The COST Web site (www.statetax.org) was visited on November 30, 2005 to obtain list of current board members. COST has adopted a formal policy resolution stating that enactment of a “physical presence” BAT nexus standard is a *quid pro quo* for expanded state authority to require non-physically-present merchants to collect and remit sales taxes (and vice-versa). COST has also adopted a second statement on what such BAT nexus legislation should contain. A spokesperson for COST wrote that H.R. 3220 satisfied all the requirements for BAT nexus legislation set forth in the policy statement, meaning that COST supported the enactment of H.R. 3220 in conjunction with legislation empowering states to impose their sales taxes on remote sales. See: Stephen Kranz, “COST Supports Federal Legislation with Carrot-and-BAT Approach,” *State Tax Notes*, October 20, 2003. “Alone, H.R. 3220 meets the ‘musts’ and ‘shoulds’ of the COST Policy Statement on business activity tax nexus and has our support in that regard.” Again, H.R. 3220 is virtually identical to H.R. 1956.

¹⁰ Testimony of Arthur Rosen, representing the Coalition for Rational and Fair Taxation (CRAFT), on H.R. 2526, before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, September 11, 2001. H.R. 2526 was the version of the BAT nexus legislation introduced in the 107th Congress.

¹¹ The membership list of the Internet Tax Fairness Coalition was still available on the Web as of November 30, 2005, at <http://www.salestaxsimplification.org/members/default.htm>. A letter dated June 4, 2001 posted at ITFC's Web site (http://www.salestaxsimplification.org/documents/Gregg_Allen.doc) expresses support for S. 664, a predecessor bill to H.R. 1956.

¹² Testimony in support of H.R. 3220 before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004.

CRAFT is not the only organization that has used state adoption of an unfair single sales factor apportionment formula to justify its support for BAT nexus legislation at the same time that its own members were lobbying for the formula in some states. The Chair of the (now defunct) Internet Tax Fairness Coalition said in a debate in December 2001: “[T]he states play games with that three-factor apportionment formula and then proceed to increase taxes on out-of-state businesses and reduce taxes on their in-state businesses. . . . [Y]ou’ve got states that are less populated and don’t have as much business activity trying to finance the construction of their infrastructure on the backs of out-of-state businesses. And that’s not fair, if you want to talk about fairness.” ITFC Chairman Mark Nebergall, quoted in Doug Sheppard, “MTC Counsel, High-Tech Rep Debate Business Activity Tax Nexus,” *State Tax Notes*, December 3, 2001. As noted in the body of this report, ITFC members Apple Computer, Cisco Systems, Oracle, and Sun Microsystems were all lobbying for the enactment of single sales factor legislation in California around the time that Nebergall made this statement.

¹³ See Chapter V of the source cited in Note 2.

¹⁴ Other commentators have noted that the enactment of federal BAT nexus legislation like H.R. 1956, combined with single sales factor apportionment, would lead to additional revenue losses for states: “The proposed legislation . . . would expand the scope for the creation of nowhere income, and thus aggravate the opportunities for tax planning and the revenue loss created by Public Law 86-272. This is especially true in states where sales are the only or primary factor used to apportion income — a rule that has been advocated by many of the same business interests that are seeking a physical presence nexus rule for BAT.” Source: Charles E. McLure Jr. and Walter Hellerstein, “Congressional Intervention in State Taxation: A Normative Analysis of Three Proposals,” *State Tax Notes*, March 1, 2004. Elsewhere, Hellerstein has used somewhat more forceful language: “One of the most appalling notions or developments is that on the one hand, you have this idea that . . . if all you’re doing is selling into a state without a physical presence there . . . there’s no appropriate basis for imposing a business activity tax. . . . And in the next breath, ‘Oh, by the way, what’s the right way to assign income? Based on where your sales are, regardless of whether you’re there or not.’ Something’s rotten in Denmark. You can’t have it both ways.” Quoted in: Doug Sheppard, “What’s the Appropriate Standard for Business Activity Tax Nexus?” *State Tax Notes*, March 4, 2002.

¹⁵ For a more in-depth discussion of the ways in which H.R. 1956 would protect corporations from establishing nexus, see: Michael Mazerov, *Proposed “Business Activity Tax Nexus” Legislation Would Seriously Undermine State Taxes On Corporate Profits And Harm The Economy*, Center on Budget and Policy Priorities, Revised May 9, 2005.

¹⁶ The qualifier “substantially” must be used here because states do not all tax corporate income at the same rates and do not define taxable corporate income in the same way. Even if every state adopted a single sales factor formula, a corporation that was taxable (“had nexus”) in every one of them might experience a net increase or reduction in its aggregate state corporate tax liability depending upon whether its sales were in states with relatively high or low tax rates. Interstate variation in the definition of taxable income could have the same effect.

¹⁷ States can and do put certain “fallback” rules into their corporate income tax codes to ensure that if a corporation does not have nexus in a state to which its income is assigned by the apportionment formula, that income is taxed by a different state or states. These rules — technically known as “throwback” and “throwout” rules — are needed to prevent “nowhere income” even under current law, because Public Law 86-272 often protects corporations from creating nexus in states in which they have substantial sales. The “throwback” rule, for example, effectively “throws back” to the state from which goods are shipped to their final customer any profits that the customer’s state is barred from taxing. (See the source cited in Note 2 for a detailed discussion of the interaction of a single sales factor formula and the throwback rule.)

The adoption by all states of a single sales factor formula, combined with the enactment of a bill like H.R. 1956, would lead to substantial “nowhere income” notwithstanding state potential to implement “throwback” and “throwout” rules. The reasons for this are as follows:

- Only about half the states with corporate income taxes have any type of throwback or throwout rule in effect.
- Except for a handful of states, the throwback/throwout rules that *are* in effect only apply to sales of goods. Since H.R. 1956 would — for the first time — drastically limit the ability of states to assert nexus over physically-present sellers of services, many states would have to enact a throwback/throwout rule covering services to prevent H.R. 1956 from creating vast amounts of untaxed profits for service businesses.
- Almost no states have in effect a throwback/throwout rule that applies to personnel and property. Since H.R. 1956 would enable some corporations to have substantial amounts of personnel and property in another state without creating nexus there (see the Appendix of the source cited in Note 15), substantial “nowhere income” would be created if states did not enact throwback rules for payroll and property in addition to the conventional throwback rule covering sales.
- The multistate corporate community vehemently opposes throwback/throwout rules. In the last few years, corporations have successfully lobbied against two out of three serious attempts to enact these rules in states that had not previously done so. (Throwback rules were defeated in Maryland and North Carolina; a throwout rule was enacted in New Jersey.)
- Procedural hurdles exist in a significant number of states that would make it quite difficult to enact throwback/throwout rules to protect state tax bases from the revenue-reducing effects of H.R. 1956. Once the legislation went into effect and revenues began to fall, enacting these rules to offset the revenue decline would be tagged as a “tax increase.” In nearly a dozen states, all tax increases require supermajority approval in the state legislature. In two more, tax increases even require approval in a statewide referendum. Obviously, such requirements would make it even less likely that these rules could be enacted into state law.

¹⁸ Testimony of Arthur R. Rosen, representing the Coalition for Rational and Fair Taxation, in support of H.R. 3220, before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004.

¹⁹ A corporation with all of its sales, property, and employees in a single state is subject to taxation there of all of its income regardless of the apportionment formula adopted by the state.

²⁰ See the discussion of the Delaware intangible holding company tax shelter in the source cited in Note 15. See also: 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; Glenn R. Simpson, “A Tax Maneuver in Delaware Puts Squeeze on Other States,” *Wall Street Journal*, August 9, 2002.

²¹ See: Multistate Tax Commission, *Federalism at Risk*, June 2003, Appendix D: Factor Presence Nexus Standard. Available at <http://www.mtc.gov/Federalism/FedatRisk--FINALREPORT.pdf>.