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FEDERAL "BUSINESS ACTIVITY TAX NEXUS" LEGISLATION:
Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes

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Summary

Major multistate corporations are engaged in a two-pronged lobbying 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 persuaded 22 states to enact — lowers corporate taxes for some *in-state* corporations and increases them for some *out-of-state* corporations. The federal legislation would make it much more difficult for states to require many of those out-of-state corporations to pay *any* income tax to them at all. Since federal law supersedes state law, the net effect would be to lower the taxes of the in-state corporations and eliminate them entirely for the out-of-state corporations. In other words, 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 federal legislation is H.R. 1439, the "Business Activity Tax Simplification Act of 2011" (BATSA). Like similar proposals filed in past years, H.R. 1439 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 44 states and the District of Columbia are the most widely-levied state business activity taxes and are the focus of this report. 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 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 BATSA proposes to do so in four key ways:

- BATSA 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, BATSA would reverse nearly a dozen state court decisions holding that physical presence is *not* required to establish nexus under a corporate income tax or other BAT.

- Under BATSA, moreover, 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 employees nor property is present in the state for more than 14 days within a particular year. (As discussed in another Center report, this 14 day limit can be easily circumvented.)[1]

- BATSA 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; it may be conducted by an unlimited number of salespeople and on an unlimited number of days in the tax year. BATSA would expand the coverage of P.L. 86-272 to the entire service sector of the economy, apply it to all types of BATs (not just income taxes), and apply it to several activities in addition to "solicitation of orders" (such as "gathering information").

- BATSA would impose tight 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, BATSA 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.[2]

The fact that BATSA's enactment would raise state corporate income tax nexus thresholds means that the profits of particular corporations would no longer be subject to tax in particular states. By itself, that would not necessarily cause states as a whole to lose corporate income tax revenue. However, many of the same corporations pushing for BATSA have successfully lobbied for complementary changes in *state* corporate income tax laws. These state laws (and similar state laws proposed in many other states) ensure that the enactment of legislation like BATSA *would* result in a substantial corporate tax revenue loss for states in the aggregate:

- Multistate corporations have convinced policymakers in 22 states to switch to a so-called single sales factor apportionment formula. 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.

- A corporation that produces all of its goods in single sales factor states but has all of its customers in other states will have *no* corporate income tax liability to the states 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 BATSA, then *all* of this corporation's profit would become "nowhere income" — profit not subject to tax by *any* state.[3]

- 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 BATSA they would likely have nexus in some other states as well. So most multistate corporations would continue to pay *some* state corporate income taxes even if BATSA were to be enacted.

- Nonetheless, if the state corporate income tax nexus threshold were raised sharply by new federal legislation, the already widespread adoption of single sales factor apportionment formulas would interact with BATSA 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 BATSA's enactment, notwithstanding past 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 $50 billion in annual revenue — would harm states already struggling to provide adequate education, health care, homeland security, infrastructure, and other critical services. In 2006, the Congressional Budget Office estimated that the enactment of a less restrictive version of BATSA would cost states $3 billion in lost revenue annually within three years of enactment.[4] Almost a dozen states have implemented single sales factor apportionment formulas since that time, meaning that the revenue loss today would be significantly greater.[5]

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 BATSA 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.

The remainder of this paper explains these points in more detail.

Disingenuous Corporate Rhetoric

BATSA proponents say the legislation is necessary because states are 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.[6] (See the text box on the following page for a debunking of this claim by two leading state tax experts.)

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

BATSA proponents 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 supporting BATSA — have lobbied at the *state* level for a change in state corporate tax policy that *intentionally* targets out-of-state businesses for heavier taxation. In some 22 states — including most of the largest ones — individual corporations and the trade associations to which they belong have lobbied successfully 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 (if they have significant out-of-state sales) and *onto* corporations that have sales but 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 this 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 corporations with greater physical presence in a state paying more income tax. 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 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.[7] 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.

Since the mid 1990s, 19 states have switched from some variant of the traditional apportionment formula to a single sales factor formula — joining three other states that had enacted it prior to that time.[8] (One additional state, Pennsylvania, has adopted an apportionment formula that operates in essentially the same manner.) In nearly every case, this change was urged on the state by major multistate corporations having a substantial physical presence within the state's borders. Moreover, multistate corporations continue to seek enactment of a single sales factor formula in several other states, including Florida, Rhode Island, and Utah.

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.[9]

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

- Lobbying reports filed with the Secretary of State's office in California reveal that the membership of the "Coalition for a Competitive California" that achieved the enactment of single sales factor legislation there in early 2009 included Apple Computer, CBS, Chevron, Cisco Systems, General Electric, Intel, Johnson & Johnson, NBC Universal, Occidental Petroleum, Oracle, Roche, Sony, Time Warner, and Walt Disney.[10] When California voters were given the opportunity in November 2010 to repeal the single sales factor formula,

corporations funding the "No on [Proposition] 24" campaign included several of the above-named companies, plus Abbott Laboratories, Amgen, Hewlett-Packard, Pfizer, and Viacom.[11]

- In Arizona, past supporters of proposed single sales factor bills included AT&T, American Express, Honeywell, Boeing, Intel, and Raytheon.[12]

- In Oregon, members of the Smart Growth Coalition lobbying for single sales factor legislation included Intel and Nike.[13]

- In Georgia, corporations lobbying for single sales factor legislation in 2005 included Coca-Cola, General Electric, and Georgia-Pacific.[14]

- The Indiana Single Sales Factor Coalition that achieved enactment there in 2006 included Alcoa, Caterpillar, Eli Lilly, General Motors, and Whirlpool.

- In Pennsylvania, the CompetePA Coalition that successfully lobbied for an apportionment formula that gives a 90 percent weight to sales and continues to work for a 100 percent sales factor formula included Bayer Corporation, Dick's Sporting Goods, General Electric, H.J. Heinz, Johnson & Johnson, and Sanofi-Aventis.[15]

Every one of these corporations that has actively supported state adoption of a single sales factor formula also supports the enactment of BATSA and/or is a member of an organization that supports BATSA:

- Alcoa, American Express, Apple, Bayer, Caterpillar, CBS, Dick's Sporting Goods, General Electric, Johnson & Johnson, Sanofi-Aventis, Sony, Time Warner, Viacom, and Walt Disney are all signatories to a May 4, 2011 letter listing the individual corporations and trade associations that support BATSA.[16]

- Twelve of these 14 corporations, and every other individual corporation named above, is a member of the Council on State Taxation, a trade association representing the largest multistate corporations in the country. COST also supports BATSA.[17]

- It seems likely that many (if not all) of the corporations identified above as supporters of single sales factor legislation in one or more states are members of the American Financial Services Association, Consumer Electronics Association, National Association of Manufacturers, and/or U.S. Chamber of Commerce, all of which support BATSA.

In sum, even as organizations to which they belong 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 BATSA to put a stop to this, at least 35 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. Ironically, some BATSA proponents have gone so far as to argue that federal BAT nexus legislation is needed *because* states have enacted this discriminatory formula:

- The Tax Foundation recently testified: "In recent years, we at the Tax Foundation have monitored the increasing use of tax policy by states to shift tax burdens away from (voting) residents toward non-residents. . . . [such as] . . . the decision by about half the states to adopt an 'economic nexus' standard for business activity taxes, whereby businesses that have no property or employees within the state must nevertheless pay these taxes. . . . At the same time, states are giving in-state businesses exemptions, waivers, and credits from their corporate income tax. . . . [For example, m]any states do not consider in-state property or payroll when apportioning taxes owed by in-state corporations. . . . It. . . results in a paradox: states excuse some resident businesses from paying part of their tax bills, while they demand that nonresident businesses pay taxes on profits that are properly taxed by other states."[18]

- A coalition of pro-BATSA corporations told Congress: "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."[19]

Of course, these accusations ignore the fact that single sales factor apportionment has proliferated due to aggressive lobbying by major multistate corporations. Still, they are correct; the single sales factor formula is a 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.[20] The solution is to solve the problem directly by discouraging states from switching to the formula or even, perhaps, banning it through federal legislation. It would be profoundly unfair, however, for Congress to reward the corporations that have foisted single sales factor apportionment on the states with draconian legislation like BATSA that would slash corporate tax liability.

(See the text box on the following page for discussion of how another key argument offered in support of BATSA is inconsistent with the pursuit at the state level of a single sales factor apportionment formula.)

Evisceration of the State Corporate Income Tax

While it is disingenuous of business representatives to justify their support for BATSA 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, they are nonetheless pursuing their narrow self-interest in a quite rational manner. Widespread enactment of a single sales factor formula at the state level and the enactment of BATSA are two complementary prongs of an attack

Another Argument in Favor of Federal Nexus Legislation Is Inconsistent With Corporate Support for the Single Sales Factor Formula

In recent congressional testimony in support of BATSA, 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 only pay tax where they *earn* income. It may be true that without sales there can be no income. But, while this may make for a nice sound bite, it simply is not relevant. Economists agree 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. . . . [T]he location of a business's customers is irrelevant because a business earns its income where it actually engages in business activities – in other words, where it has a physical presence.

In making this argument, CRAFT's lobbyist is taking issue not with a "nice sound bite" from state tax officials, but rather with a more than 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 implied 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 and/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 BATSA represents 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."

on the corporate income tax aimed at eviscerating this much-despised (by multistate 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 (more specifically, in-state corporations with significant out-of-state sales) 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 BATSA, however, would likely magnify the revenue loss from the switch to a single sales factor formula several times over.[21] Due to all the new "safe harbor" provisions in the legislation, 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, BATSA would expand P.L. 86-272 to cover all multistate service businesses, like banks and television networks. BATSA 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.[22]

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 BATSA 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. Indeed, this is precisely what has occurred; the number of single sales factor states grew from 5 to 22 just since 2000. 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).[23]

The enactment of BATSA, 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, BATSA 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. (BATSA 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 BATSA, 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.[24]

In short, the effort by the multistate corporate community to enact BATSA 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 fully one-half 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 several more. In light of widespread, corporate success in enacting the single sales factor formula, past claims by BATSA proponents 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.[25] Perhaps that is why such claims have virtually disappeared from pro-BATSA lobbying documents.

With the bulk of corporate output in the U.S. economy covered by single sales factor apportionment rules and BATSA 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.[26] With those businesses 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 BATSA, 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 BATSA, it would do considerable damage to state and local governments and the people and businesses that depend on them for education, health care, protection from crime, and scores of other essential services; the state corporate income tax generated $50 billion in revenue in fiscal year 2009. Alternatively, states might choose to replace the revenue from the corporate income tax by raising other taxes, again with primary impacts on individual residents and smaller, wholly in-state businesses.

Reasonable Alternatives to BATSA 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 the vast majority of 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 BATSA proponents that states are engaged in aggressive new efforts to assert nexus over out-of-state corporations with no physical presence whatsoever within their borders, the 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.[27] Even if Congress did decide it should enact new BAT nexus legislation under its authority to regulate interstate commerce, rational and fair alternatives to BATSA 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.[28] At a time when there is growing 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 BATSA that would severely undermine the same — and equally-critical — source of revenue for states.

Notes

[1] 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, updated April 13, 2011; http://www.cbpp.org/cms/index.cfm?fa=view&id=424. See especially pp. 3-5 of the Appendix to this report, at http://www.cbpp.org/files/6-24-08sfp-appendix.pdf.

[2] See the sources cited in Note 1 for a detailed discussion of the myriad ways in which BATSA would enable sophisticated multistate corporations to shelter their profits from taxation.

[3] If the corporation in the example were producing its wares in certain states, it might not entirely avoid state corporate income taxes. Some states have "throwback rules" in place that ensure that the corporation's home state taxes effectively profits earned in states in which the corporation has no nexus. Some states also require corporations to have nexus in at least two states before they can apportion their income. Corporations can often circumvent these policies, however. For example, corporations can avoid the throwback rule by selling and delivering their production to a subsidiary operating a warehouse in a state without the rule in effect. They can get around the second rule by deliberately creating nexus in just one state outside their home state in which they don't have substantial sales (thereby paying a small amount of tax). This ensures that they are able to assign the rest of their profits to states in which they have *not* crossed the nexus threshold — thus avoiding tax on those profits.

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

[5] Arizona, California, Colorado, Maine, Michigan, New Jersey, and South Carolina all enacted single sales factor formulas after July 2006, when the Congressional Budget Office prepared its BATSA revenue loss estimate. Pennsylvania's adoption of a 90 percent sales factor weight also occurred after that date. Georgia, Indiana, Minnesota, New York, and Wisconsin were phasing in single sales factor formulas as of the time of the CBO estimate, and it is unclear whether the estimate took account of the higher revenue loss that would occur after full phase-in.

[6] "Specifically, some state revenue departments have asserted that they can tax a business based merely on its economic presence in the state. . . Such behavior is entirely understandable 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. 1439, submitted to the Subcommittee on Courts, Administrative and Commercial Law, House Judiciary Committee, April 13, 2011. Emphasis added.

[7] But see the caveats in Note 2 above. 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; http://www.cbpp.org/3-27-01sfp.pdf

[8] Since 1994, Arizona, California, Colorado, Connecticut, Georgia, Illinois, Indiana, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, Oregon, South Carolina, Virginia, and Wisconsin have adopted a single sales factor formula for manufacturers only or for all corporations. Iowa, Missouri, and Nebraska had adopted a single sales factor formula at an earlier date.

[9] The main justification corporations offer 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, for which it was chided by a number of columnists. Much more recently, Fidelity Investments created a firestorm of controversy by announcing plans to close a facility in Massachusetts and move the employees to Rhode Island and New Hampshire. Fidelity had demanded and was granted single sales factor apportionment by Massachusetts in 1996. (See: Greg Turner and Hillary Chabot, "Senator Calls for End to 'Sweetheart' Deals," *Boston Herald*, March 17, 2011.) 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.

[10] Form 635, "Report of Lobbying Coalition," filed with California Secretary of State with respect to then-pending single sales factor legislation by the "Coalition for a Competitive California," April 21, 2008.

[11] Information filed with the California Secretary of State by "No on 24 – Stop the Jobs Tax, A Coalition of Taxpayers, Employers, Small Businesses, Educators, and High Tech and Biotechnology Organizations," for the 2009 through 2010 election cycle.

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

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

[14] 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.

[15] Membership list of the CompetePA Coalition, available at http://www.alleghenyconference.org/competepa/PDFs/CompetePACoalitionMembers.pdf.

[16] Letter in support of BATSA dated May 4, 2011 to House Judiciary Committee Chairman Lamar Smith and Subcommittee on Courts, Commercial and Administrative Law Chairman Howard Coble.

[17] Council on State Taxation 2010 Annual Report. Dick's Sporting Goods and Sanofi-Aventis are not listed there as COST members.

COST itself does not lobby at the state level either in favor of or in opposition to single sales factor apportionment. Nonetheless, COST is an instrumentality of its membership. While many of those members are lobbying in support of single sales factor formulas at the state level, COST as an organization is working at the federal level to have BATSA enacted, helping those corporations achieve their goal of having a larger share of their profits be "nowhere income." Moreover, the COST members that are identified in the body of the report as having supported single sales factor apportionment in the states are quite influential in the organization; 6 of the 7 current officers of COST work for these corporations, as do 10 of the 23 corporate representatives currently holding seats on COST's board of directors. See: http://www.cost.org/COSTBoard.aspx.

[18] Written statement of Joseph Henchman, Tax Foundation, in support of the Business Activity Tax Simplification Act of 2011, hearing before the Subcommittee on Courts, Commercial, and Administrative Law, House Committee on the Judiciary, April 13, 2011.

[19] Testimony of the Coalition for Rational and Fair Taxation (CRAFT) in support of H.R. 3220 before the Subcommittee on Administrative and Commercial Law, House Judiciary Committee, May 13, 2004.

[20] See Chapter V of the source cited in Note 7.

[21] Other tax experts have noted that the enactment of BATSA, 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.

[22] For a more in-depth discussion of the ways in which BATSA would protect corporations from establishing nexus, see the source cited in Note 1.

[23] 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.

[24] As discussed briefly in Note 3, 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 7 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 BATSA 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 generally only apply to sales of goods. Since BATSA 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 BATSA 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 BATSA 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 1), 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 numerous proposals to enact them, including a proposal put forward this year by the Governor of Connecticut. New Jersey repealed its throwout rule in 2010. Only Rhode Island has enacted a throwback rule in recent years.

- 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 BATSA. 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.

[25] See, for example, 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.

[26] 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.

[27] See the discussion of the Delaware intangible holding company tax shelter in the source cited in Note 1. 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.

[28] See: Multistate Tax Commission, *Federalism at Risk*, June 2003, Appendix D: Factor Presence Nexus Standard. Available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Studies_and_Reports/Federalism_at_Risk/FedatRisk--FINALREPORT.pdf