
Revised December 22, 2005

CLAIM THAT PROPOSED FEDERAL “BUSINESS ACTIVITY TAX NEXUS” BILL WOULD HAVE A NEGLIGIBLE IMPACT ON STATE REVENUE IS FALSE AND DISINGENUOUS

By Michael Mazerov

Background and Summary

A bill under consideration in the U.S. House of Representatives would strip states of authority they currently have to tax a fair share of the profits of many corporations that are based out of state but do business within their borders. H.R. 1956, the “Business Activity Tax Simplification Act of 2005,” was introduced in April 2005 by Representatives Bob Goodlatte and Rick Boucher.¹ The bill was approved (with minor amendments) by the Subcommittee on Administrative and Commercial Law of the Judiciary Committee on December 13, 2005. The National Governors Association has estimated that states could lose \$4.7 billion to \$8.0 billion annually if this bill is enacted.²

What the Bill Does

H.R. 1956 would impose what is usually referred to as a federally-mandated “nexus” threshold for state (and local) “business activity taxes” (BATs).³ State taxes on corporate profits are the most widely-levied state business activity taxes. The term also encompasses such broad-based business taxes as the Michigan Single Business Tax (a form of value-added tax) and the Washington Business and Occupations Tax (a state tax on a firm’s 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 governing business taxation will set forth the types of activities conducted by a business within the state that obligate the business to pay the tax. If a business engages in any of those activities within the state it is said to have “created” or “established” nexus with the state, and it therefore must pay the tax on its in-state activities. 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 proposes to 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 Commerce Clause of the U.S. Constitution.

- Under H.R. 1956, moreover, some businesses could have a substantial 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 is present in the state for more than 21 days within a particular year.⁴
- H.R. 1956 substantially expands an existing nexus “safe harbor” enacted in 1959, 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 (including residents of the state who work out of home offices). 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 the state’s borders by a (non-employee) individual or other business acting on behalf of the out-of-state business.

Why the Claim of a “Negligible” State Revenue Loss Is False

A previously-issued Center on Budget and Policy Priorities report explains why and how these new restrictions on the authority of states to impose taxes on many out-of-state corporations would directly reduce state BAT revenues and open up broad new opportunities for corporations to avoid paying state taxes on a large share of their profits. (See: Michael Mazerov, *Proposed “Business Activity Tax Nexus” Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy*, May 9, 2005, www.cbpp.org/9-14-04sfp.htm. Hereafter referred to as “the Center analysis of H.R. 1956.”) As noted, the National Governors Association has estimated that the enactment of H.R. 1956 would lead to state revenue losses of between \$4.7 billion and \$8.0 billion annually.

Proponents of H.R. 1956 vehemently dispute these analyses. They claim that H.R. 1956 would not — and is not intended to — reduce the aggregate amount of business activity taxes corporations pay to the 50 states collectively.

Underlying the claim that the enactment of H.R. 1956 would have no more than a “negligible” revenue impact on the states are a number of more specific assertions. These have been laid out in the greatest detail by the “Coalition for Rational and Fair Taxation” (CRAFT), which has been organized to lobby for the enactment of federal BAT nexus legislation.⁵ These assertions — and their rebuttals— are as follows:

- *Assertion.* States will not lose any revenue from the bill’s imposition of a true “physical

presence” nexus threshold, that is, its declaration that “no taxing authority of a State shall have the power to impose . . . a net income tax or other business activity tax on any person . . . unless such person has a physical presence in the State”⁶ Notwithstanding state laws that assert BAT nexus is created by in-state sales alone, states simply are not collecting revenue from corporations that truly have no employees or property within their borders because court decisions have made clear such laws are unconstitutional. Accordingly, merely codifying a “physical presence” nexus threshold in a federal statute would not have any adverse impact on existing state revenues.

Rebuttal: Although the state of the law is unclear, a number of state courts have held that “physical presence” is *not* required under the Constitution for a state to impose a BAT on an out-of-state company that is earning income by making sales to its residents. Accordingly, a company that chooses to flout state laws that impose BATs on non-physically-present sellers risks incurring substantial penalty and interest payments. For this reason — and backed by some concrete evidence from ongoing litigation in Massachusetts — it seems likely that certain kinds of businesses, such as banks and franchisors, *do* pay corporate income taxes to states in which they have no employees or physical property.⁷ In any case, this provision of H.R. 1956 is the least significant one with respect to its potential impact on state revenues, because Public Law 86-272 *already* effectively imposes a physical presence nexus threshold on the entire goods-producing and goods-selling sector of the U.S. economy.

- *Assertion:* Those corporations that would be protected from nexus in certain states by the “safe harbors” in H.R. 1956 declaring certain types of actual physical presence to be non-nexus-creating do not supply a “material amount of revenue” to such states. Therefore, enactment of the safe harbors would not result in a significant revenue loss.

Rebuttal: The “safe harbor” provisions in H.R. 1956 that declare that BAT nexus will not be created by certain categories of physical presence within a state represent a vast expansion of the safe harbors available under P.L. 86-272. Taken together, these new safe harbors will ensure that few corporations will be taxable in states in which they do not have a permanent, “brick and mortar” facility. (See the previously-cited Center analysis of H.R. 1956 for a detailed explanation of why this is the case.) Under current law, in contrast, numerous corporations now have BAT nexus in multiple states because they temporarily maintain property and/or employees in the states or hire other businesses to represent them. If a company makes substantial sales in a state it can have a large tax liability to that state notwithstanding the fact that its physical presence there is relatively limited. Indeed, in an increasing number of states, the level of sales in the state is the *only* factor that determines how much tax a corporation with nexus owes.⁸ By ensuring that temporary physical presence would rarely create BAT nexus, the enactment of H.R. 1956 would eliminate significant tax payments to numerous states made by out-of-state corporations lacking a permanent presence within their borders.

- *Assertion:* The fact that particular corporations are protected from taxation in particular states by provisions of H.R. 1956 does not mean that these businesses’ profits go completely untaxed. The legislation simply results in those profits or sales being taxed by the “appropriate jurisdiction,” that is, the jurisdiction that has a legitimate right to tax the profits or sales based on public services it provides to the physically-present business.

Rebuttal: About half the states do have laws in effect that ensure that if a corporation earns

profit in a state in which its level of activity is insufficient to put it across the nexus threshold, that profit effectively will be taxed in one or more states in which it *does* have nexus. But the business community vehemently opposes these so-called “throwback rules” and has been very successful in blocking additional states from enacting them. Opposition by business and procedural hurdles, such as legislative “supermajority” requirements for tax increases, would make it extremely difficult to enact these fallbacks. As a result of the continuing lack of throwback rules in a large number of states, a substantial share of the profit earned by corporations that states would no longer have the authority to tax under H.R. 1956 would be “nowhere income” not taxed by *any* state. Collectively, states would lose significant amounts of corporate tax revenues were H.R. 1956 to be enacted.

- *Assertion.* Assuming for the sake of argument that the enactment of H.R. 1956 would create some new opportunities for corporations to shelter their profits from taxation by restructuring their operations, states have ample mechanisms available to them to nullify these “tax planning” opportunities.

Rebuttal: In addition to “throwback rules,” proponents of H.R. 1956 cite a variety of other tax policy reforms that states could adopt to nullify any “hypothetical” tax-avoidance opportunities that would be opened up by the enactment of the bill. Most often cited are corporate income tax policies known as “royalty addback” laws and “combined reporting.” As they are with respect to “throwback rules,” these claims are disingenuous. The same business interests that are pushing H.R. 1956 have largely blocked states from enacting these policies or made sure that they were enacted in a substantially watered-down form. For example, only 16 of 45 states with corporate income taxes use “combined reporting,” and business opposition blocked its enactment in 11 of the 12 states in which combined reporting bills were introduced in the last three years. Royalty addback laws only nullify one of the many tax-avoidance opportunities opened up by H.R. 1956, and they have been enacted by only a dozen or so states in any case. Other potential tools that states could use to nullify tax-sheltering opportunities opened up by H.R. 1956, such as legal challenges based on the “sham transaction doctrine,” have a high burden of proof and require substantial legal and accounting resources to litigate successfully; few states could afford to bring such cases. Moreover, well-advised companies would have little difficulty in giving their tax-shelter arrangements sufficient economic substance to avoid nullification under this doctrine.

H.R. 1956 is intended to — and would— block states from taxing the profits of many corporations they are now taxing. While in theory state laws could be rewritten both to ensure that these no-longer-taxable profits are taxed by other states and to nullify many of the various tax sheltering opportunities the bill would open up, the business community has an excellent track record in stopping state efforts to close corporate tax loopholes. There is little doubt that the overall effect of H.R. 1956 would be to reduce significantly the aggregate amount of business activity taxes that corporations pay to the states collectively.

Are States Collecting BAT Revenues from Companies with No Physical Presence Within Their Borders?

The September 27, 2005 letter to the House Judiciary Subcommittee on Commercial and Administrative Law in support of H.R. 1956 by the Coalition on Rational and Fair Taxation (hereafter, “CRAFT Statement”) declares:

There simply is no basis for the assertion that H.R. 1956 could lead to any meaningful loss of state revenues . . . H.R. 1956 does not depart to any significant degree from what is now being done in the states. . . . Outside the context of passive investment companies . . . state revenue departments simply have not been successful in their attempts to assert economic nexus to impose tax on businesses that do not have a physical presence in the state.

“Economic nexus” refers to state laws that require a corporation to pay a corporate income tax or other BAT to the state if it makes significant sales to customers in the state, notwithstanding the corporation’s lack of physical presence within the state’s borders. CRAFT is alleging that virtually no corporations pay a corporate income tax or other BAT to jurisdictions in which they only make sales because the U.S. Supreme Court’s 1992 *Quill* decision and a few state court decisions make clear that state statutes asserting the existence of nexus based on in-state sales alone are unconstitutional. Accordingly, H.R. 1956’s “codification” of a true “physical presence” nexus threshold will not cause states to lose revenues they are currently collecting. (Again, the “true” physical presence nexus threshold in H.R. 1956 is imposed by its declaration that “no taxing authority of a State shall have the power to impose . . . a net income tax or other business activity tax on any person . . . unless such person has a physical presence in the State”)

Before addressing the merits of CRAFT’s claim that virtually no corporation will pay a BAT to a state in which it truly has no physical presence, it should be noted that the provision of H.R. 1956 at issue here is arguably the least significant feature of the proposed legislation. As discussed at length in the previously-cited Center analysis of the bill, H.R. 1956’s extension of Public Law 86-272 to the service sector of the U.S. economy and its creation of new physical presence safe harbors are the provisions that would do the most damage to state and local revenues. The imposition of a true “physical presence” threshold would have a much less significant impact — largely because Public Law 86-272 *already* effectively imposes such a threshold on the entire goods-producing and goods-selling sector of the economy with respect to the most significant state BAT, the corporate income tax. That is, P.L. 86-272 already ensures that the sale of goods to customers in a state by a non-physically-present seller does not create corporate income tax nexus for the seller as long as the shipment to the customer originates at the seller’s out-of-state warehouse or factory.⁹

Some Types of Businesses Likely Pay BATs to States in Which They Are Not “Physically Present”

With regard to the service sector of the economy *not* covered by P.L. 86-272, however, the validity of CRAFT’s claim that “state revenue departments simply have not been successful in their attempts to assert economic nexus to impose tax on businesses that do not have a physical presence in the state” is a straightforward issue of fact. Unfortunately, the revelation of those facts is completely controlled by the same corporations lobbying for H.R. 1956; whether or not corporations are paying

taxes to particular states is confidential taxpayer information. Thus, even if state and local officials are aware of non-physically-present corporations in service industries that *are* paying BATs into their treasuries, they are prohibited from naming them.

Despite the absence of documentation, it seems likely that states *are* collecting non-trivial amounts of BAT revenues from at least certain types of service businesses that do not have any employees or physical property within their borders. Several state courts have held that “physical presence” is *not* the minimum nexus threshold for BATs required by the U.S. Constitution, and a number have ruled to the contrary.¹⁰ Therefore, except in the few states where state courts have issued clearly contrary and broadly-applicable rulings, a responsible attorney could not advise a service business that it would bear no risk in declining to comply with a state’s assertion of an “economic presence” nexus standard. The fact that companies could be liable for significant penalty and interest payments if they failed to file a corporate income tax return might lead some of them to comply with an “economic presence” nexus threshold.

Financial institutions and franchisors (such as fast-food chains) are two examples of the types of service businesses that might decide to pay corporate income taxes to states in which they lack a physical presence. Approximately one-third of the states levying corporate income taxes take the position that if an out-of-state bank or other lender loans money to an individual for the purchase of a house or a car, and the lender retains the right to repossess the house or car until the loan is paid off (which of course is almost always the case), then this *by itself* creates corporate income tax nexus for the lender. In the same survey, more than half the corporate income tax states take the position that if a franchisor has an independent franchisee in the state from which it is receiving royalty payments or “franchise fees,” this is sufficient to create corporate income tax nexus for the franchisor.¹¹ Because financial institutions and franchisors have a substantial and ongoing financial interest in physical property (in the case of a lender whose loans are secured by houses and cars) or in a business (in the case of a franchisor) that is located in another state, they may well choose to “play it safe” and pay a corporate income tax to the states where their borrowers and franchisees are located, even if they do not physically enter those states.

As noted above, the information needed to prove that corporations like banks and franchisors are paying BATs to states in which they are not physically present is confidential and cannot be revealed by state and local officials. Thus, the preceding discussion is only conjecture. However, there is some evidence from ongoing litigation in Massachusetts that major financial institutions owning no tangible property and having no employees in the state nonetheless are paying corporate income taxes there.

Since 1995, an industry-specific Massachusetts corporate income tax has been imposed on any financial institution that earns income from “regularly” engaging in transactions with state residents regardless of its physical presence in the state. Regularity is presumed to be satisfied if the business has at least 100 Massachusetts customers during any given year. Massachusetts initiated legal action to enforce this tax against many of the largest credit card-issuing banks in the United States. Many of these banks issue credit cards from a single, separately-incorporated subsidiary located in a single state. Although some of these companies are continuing to challenge Massachusetts’ tax on the grounds that the law is unconstitutional in asserting nexus in the absence of physical presence, Bank One, Chase Manhattan Bank, and Citibank all withdrew their challenges.¹² It seems highly unlikely that these companies have ceased doing business in Massachusetts. Rather, they probably concluded that the state had a reasonable prospect of having its “economic presence” nexus standard upheld in

court. Thus, it appears that some companies without a direct physical presence in Massachusetts *are* paying income taxes to the state. They would no longer be obligated to pay were H.R. 1956 to be enacted, however, meaning that the state would lose revenue it (likely) is currently collecting.

Two additional points should be made with respect to claims that H.R. 1956's imposition of a true "physical presence" nexus standard would have no adverse impact on state revenues:

- The American Bankers Association, the American Financial Services Corporation, the Securities Industries Association, and the International Franchisers Association have endorsed H.R. 1956, as have such individual franchisors as Burger King and Wendy's and individual financial institutions as American Express, Citigroup and MBNA. While this support could be motivated by a desire to prevent future state assertion of BAT nexus in states in which they have franchisees and customers (respectively), they may also be seeking to be relieved of *existing* tax liability.
- "Economic presence nexus" laws have been on the books for a decade or more in numerous states. This is ample time for states to have conducted audits of out-of-state corporations covered by these laws and for challenges to the laws' constitutionality to have become publicly visible by entering the states' court systems. The fact that a challenge to a law asserting "economic nexus" over financial institutions appears to have been lodged in only three states suggests that many such corporations may be complying with these laws in numerous states.¹³ The same may be said with respect to franchisors, where only two challenges to state BAT nexus laws in recent years are readily apparent.¹⁴ If that is the case, then H.R. 1956's voiding of "economic presence" laws and imposition of a true "physical presence" BAT nexus threshold for service industries *would*, contrary to CRAFT's claim, cause some states to lose revenue they are currently collecting from non-physically-present businesses.¹⁵

A "Physical Presence" Nexus Standard Could Lead Corporations to Eliminate Existing Nexus

The imposition of a true "physical presence" nexus standard through the enactment of H.R. 1956 could cause states to lose revenues they are currently collecting in a second, indirect way. Enactment of such a law could provide incentives for businesses to change their mode of operation and eliminate their physical presence within states.

Franchisors again provide a good illustration of this scenario. As noted above, more than half the states take the position that franchisors have corporate income tax nexus with them if the franchisors earn royalty income or franchise fees from an in-state franchisee. Since few (if any) state courts have ever held to the contrary, some franchisors may have been advised by their lawyers that these nexus laws are — or may well be — valid. Accepting that they may be taxable in their franchisees' states regardless of whether they enter them physically, the franchisors may decide that they might as well use their own employees to conduct such activities as checking up on the quality of the franchisees' operations and providing management advice and training to the franchise managers.¹⁶

If H.R. 1956 were enacted, however, franchisors would be assured that having a franchisee in a state would *not*, by itself, establish corporate income tax nexus. This could lead them to stop sending their own employees into their franchisees' states, thereby eliminating their obligation to pay

a corporate income tax to such states. (For example, they could hire third parties to do quality-control inspections at the franchisees' stores, and they could hold management training for franchisees at their own headquarters.)¹⁷ If franchisors chose to “break” their nexus with a state in this manner, this, too, would result in states losing corporate tax payments they are currently receiving as a result of the enactment of H.R. 1956.

In sum, CRAFT has not provided evidence to back up its assertion that the true “physical presence” nexus threshold imposed by H.R. 1956 would have no adverse impact on state revenues. It is quite possible — and indeed seems likely — that at least some types of service businesses are paying corporate income taxes (and perhaps other BATs) to some states in which they have no physical presence; these revenues would be lost were H.R. 1956 to be enacted. Moreover, as the franchisor example suggests, the enactment of a physical presence threshold might encourage businesses that have a physical presence in a state and are paying BATs to the state to eliminate that physical presence — further cutting into state revenues.

The Impact on State and Local Revenues of H.R. 1956's “Safe Harbors”

The U.S. Supreme Court's 1992 *Quill* decision upheld “physical presence” as the nexus threshold for state sales taxes, and a few state courts subsequently have held that physical presence is also the nexus threshold for state corporate income taxes. Given that state tax officials are prohibited from revealing hard evidence to the contrary, CRAFT's claim that states therefore are collecting no revenue from businesses that truly have no physical presence within their borders is at least plausible.

The same plausibility cannot, however, be granted to CRAFT's contention that the “physical presence” safe harbors in H.R. 1956 similarly would have a “negligible” or “minimal” impact on revenues:

H.R. 1956 would have no effect on taxes derived from businesses that maintain a facility or inventory in the jurisdiction for more than 21 days during the taxable year. Clearly state and local governments derive most — if not virtually all — of their business activity tax revenue from such businesses. The amount of revenue received by taxing jurisdictions from those businesses that maintain no office, store, warehouse, or other facility — or even inventory — in the jurisdiction at all must truly be minimal.

No one knowledgeable about state tax bases would dispute CRAFT's assertion that “state and local governments derive most . . . of their business activity tax revenue from . . . businesses” that have a permanent facility within their borders. However, there is no basis whatsoever to go further and claim that the nexus safe harbors for temporary physical presence in a state would have a “minimal” revenue impact because state and local governments collect “virtually all” of their revenues from companies that are permanently present:

- Under H.R. 1956, corporations could have an unlimited number of employees and an unlimited amount of property in a state for up to 21 days annually without creating BAT nexus. As detailed in the Center's analysis of H.R. 1956, numerous types of businesses have occasion to send employees into states in which the business has no permanent facilities. The same is true

with respect to the temporary movement into states of equipment and other property. It is entirely reasonable to assume that many businesses send their employees or property into a particular state on less than 21 different days in a calendar year to provide services to their customers. Unless it is truly trivial, there is no question that such physical presence creates BAT nexus for the company under current law; there is no legal requirement that the physical presence exceed 21 days. Thus, H.R. 1956's 21-day nexus safe harbor undoubtedly would bar states from taxing many corporations they are taxing now.

- The fact that a corporation's only physical presence in a state is the temporary presence of one or two employees and a small amount of equipment in no way means that the business' income tax payment to that state is "minimal." The actual tax payment is substantially — and in about 10 states, *exclusively* — determined by the volume of sales in the state. It is entirely possible for a corporation to have substantial sales in a state in which it has little physical presence. Nexus is "all or nothing." Thus, once the nexus threshold is crossed by a small amount of physical presence, the corporation's tax liability can immediately be significant if the business makes substantial sales in the state. It is highly misleading of CRAFT to imply elsewhere in its Statement that a "fleeting presence" results in "minimal" tax payments and therefore that the elimination of short-term physical presence as a basis for nexus would have a minimal impact on state corporate income tax revenue.
- The provision of H.R. 1956 that allows all businesses to have up to 21 days of physical presence in a state annually without creating BAT nexus is only one of many "safe harbors" in the bill. For example, the extension of Public Law 86-272 to encompass the solicitation of orders for services also would have a substantial adverse impact on state revenues. This would prohibit states from taxing out-of-state banks and TV networks that send in personnel to solicit borrowing and advertising (respectively) by in-state businesses.
- Finally, as discussed in the previous Center analysis of H.R. 1956, the most severe adverse impact of the legislation on state and local revenues would not arise from the direct effects of its specific "safe harbors."¹⁸ Rather, the greatest impact results from the enormous opportunities the bill provides to businesses to change their operations and legal structures to take advantage of those safe harbors to shelter a substantial share of their profits from taxation by any state.

In sum, the nexus "safe harbors" in H.R. 1956 for several categories of physical presence are intended to — and would — block states from imposing BATs on many businesses that they currently have the authority to tax and are taxing. The safe harbors would also open up enormous new tax-sheltering opportunities that corporations could restructure their operations to take advantage of. States (and localities) would lose substantial revenue as a result.

H.R. 1956: Revenue Loss or Revenue Shift?

CRAFT's September 27, 2005 Statement asserts:

H.R. 1956 does not seek to reduce the tax burdens borne by businesses, but merely to ensure that tax is paid to the appropriate jurisdiction.

CRAFT does not explain how, in preventing an “inappropriate” state from imposing a BAT on a particular business, H.R. 1956 also “ensure[s] that [the] tax is paid to the appropriate jurisdiction.” However, the author(s) of the CRAFT Statement may have in mind certain “fallback” mechanisms that some states have put into their corporate income tax codes. These rules — technically known as “throwback” and “throwout” rules — ensure that if a state in which a corporation is making sales and earning profits nonetheless does not have nexus over the corporation, the profits will instead automatically be taxed by one or more of the states in which the corporation *does* have nexus. These rules are needed even under current law, because Public Law 86-272 often creates this scenario. 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 because the seller does not have nexus under P.L. 86-272.¹⁹ Without the throwback rule in effect, a multistate corporation can often have 50-100 percent of its profit untaxed by any state as a result of that law. State tax practitioners often refer to such untaxed profit as “nowhere income.”²⁰

Proponents of H.R. 1956 likely have throwback and throwout rules in mind when they deny that its enactment would “reduce the tax burdens borne by businesses.”²¹ The practical ability of states to keep H.R. 1956 from resulting in a substantial net revenue loss by enacting these rules is quite different from the claims made by the bill’s proponents, however:

- Only about half the states with corporate income taxes have any type of throwback/throwout rule in effect.²²
- 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 sellers of services, many states would have to enact a throwback/throwout rule covering services to prevent H.R. 1956 from creating significant amounts of untaxed profits for service businesses.²³
- The multistate corporate community vehemently opposes throwback/throwout rules.²⁴ In the last five years, corporations have successfully lobbied against two out of three serious attempts to enact these rules in states that had not previously done so.²⁵
- 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 at least 16 states, all tax increases require supermajority approval in the state legislature. In three more, tax increases even require approval in a statewide referendum.²⁶ Obviously, such requirements would make it even less likely that these rules could be enacted into state law.

Proponents of H.R. 1956 imply that states could enact throwback/throwout rules to ensure that the enactment of the bill would lead only to a reshuffling of corporate tax liability to the “appropriate” states rather than a net loss of revenue for the states collectively. These suggestions are disingenuous in light of the already-concerted — and largely effective — efforts of the multistate corporate community to block new enactments of such rules. Indeed, many of the same multistate corporate interests that are lobbying actively for the enactment of H.R. 1956 have been working to enact complementary changes in state corporate income laws that exploit the *absence* of throwback

rules in many states. These changes in the method by which states divide corporate profits among themselves for tax purposes, combined with the absence of the throwback rule in many states and the enactment of H.R. 1956, would lead to a massive net loss of corporate income tax revenue for the states collectively. This issue is discussed in another Center report on H.R. 1956. See: Michael Mazerov, *Federal "Business Activity Tax Nexus" Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes*, Revised November 30, 2005, www.cbpp.org/1-26-05sfp.htm.

Do States Have Other Tools Available to Block New Tax Sheltering Opportunities that Would Be Opened Up by H.R. 1956?

The previously-issued Center analysis of H.R. 1956 explained how the bill's enactment would create significant new opportunities for corporations to shelter large shares of their profit from state taxation and hamstring ongoing state efforts to prevent such tax sheltering.²⁷ Proponents of BAT nexus legislation dismiss these concerns. In its September 27, 2005 Statement on H.R. 1956, for example, CRAFT derided explanations by state officials of the incentives corporations will have to restructure their operations to avoid taxes as "hypothetical" — as if they could be something other than hypothetical until such time as the legislation is enacted.

Concerns about the adverse revenue impact of H.R. 1956 are also dismissed in a slightly less rhetorical fashion: by claiming that even if they have some validity, states have ample tools available to ensure that abusive tax sheltering does not result from the enactment of H.R. 1956. The tools most commonly cited by H.R. 1956 proponents are two types of corporate tax reforms that some states have already implemented. The first is a law that an increasing number of states are trying to adopt to nullify a specific and widespread corporate tax shelter. The second is a more far-reaching state corporate tax policy some states have implemented that undermines a *variety* of corporate tax-avoidance strategies. As in the case of the "throwback rule" discussed previously, however, references to these laws by H.R. 1956 supporters are disingenuous; multistate corporations have worked vigorously in recent years to block states from adopting both of these approaches to stopping corporate tax sheltering.

Anti-Intangible Holding Company Laws

As discussed in the Center analysis of H.R. 1956, one of its effects would be to declare illegal a tactic states are using to nullify a widespread state corporate tax shelter, the so-called "intangible holding company" (IHC). In the most common use of this shelter, a corporation that operates retail stores transfers its logos and other trademarks to a subsidiary corporation it has created in a tax-haven state like Delaware or Nevada. The stores then pay royalties to this subsidiary for the right to display the trademarks. These royalties are tax-deductible (as a cost of doing business) and hence can be used to largely or entirely eliminate corporate income tax liability in the states in which the corporation is actually operating stores and earning its profits. Meanwhile, the royalty payments are not taxed by the tax-haven state. The Limited and the Gap retail chains, two corporations backing H.R. 1956, are among the thousands of corporations that have implemented the IHC tax-avoidance technique.²⁸

More than half the states with corporate income taxes seek to nullify this tax shelter by asserting that the IHC is directly taxable in any state from which it receives royalties. H.R. 1956 would close

off this avenue of attack on IHCs by providing that the presence in a state of an intangible asset like a trademark does *not* create BAT nexus for the out-of-state corporation that owns it. In so doing, H.R. 1956 would reverse court decisions in Maryland, New Jersey, New Mexico, North Carolina, and South Carolina that held that IHCs had nexus in those states, as well as invalidate the express nexus policy of some 20 additional states.²⁹

Proponents of H.R. 1956 dismiss the objections of state tax officials about its voiding of their authority to assert nexus over IHCs by arguing that states have other weapons in their arsenal to attack this tax shelter.³⁰ One of those weapons, mandating that corporations use “combined reporting” when they file their state tax returns, is discussed in the next section of this report. The other approach to nullifying IHCs that states are increasingly seeking to implement involves taking away the right of a business to deduct payments of royalties (and related interest) to an IHC. As in the case of throwback/throwout rules, however, proponents of H.R. 1956 are being less than candid in touting laws denying royalty deductions as a better solution to the IHC problem than direct assertion of nexus over the IHC:

- The IHC problem has recently received widespread attention in the popular press as a major cause of the erosion of state corporate tax revenues. Bills to deny the deductibility of royalty payments to IHCs were introduced in at least 15 state legislatures in 2003-5. Yet despite the abusive character of this tax shelter and the most severe fiscal crisis experienced by states in decades, in only three of these 15 states (Massachusetts, New York, and Maryland) were proponents of this type of legislation able to overcome fierce business opposition and enact a reasonably water-tight anti-IHC provision into law.³¹
- The Council on State Taxation, which represents over 500 major multistate corporations and supports H.R. 1956, has testified and lobbied against these royalty deduction laws in many of the states in which they have recently been proposed.³² COST has variously argued that the laws are unconstitutional or go too far because IHCs are not necessarily abusive. COST has even argued that the laws are unnecessary in states in which courts have upheld the state’s assertion of nexus over the IHC — the very policy that H.R. 1956 seeks to reverse. COST’s efforts to defeat or water-down these laws comes after it has claimed in letters and testimony supporting BAT legislation that the “states have more than sufficient power to make sure that the companies that are physically present in their states pay their fair share of taxes to those states.”³³
- Corporate representatives have written a number of major articles making the case that many of these laws are unconstitutional, laying the groundwork for a legal challenge.³⁴ One such challenge is already underway in Alabama. If these challenges ultimately succeed and direct assertion of nexus over the IHC is also barred by the enactment of H.R. 1956, then two of the three effective methods of attack against this abusive tax shelter will have been taken away from the states. (The third, “combined reporting,” is discussed in the next section.)

Combined Reporting

It is equally misleading for proponents of H.R. 1956 to claim that states could nullify some of its other potential adverse impacts on their corporate income tax revenues by adopting “combined reporting.” Combined reporting is a provision of some states’ corporate income tax laws that

effectively treats a parent corporation and its subsidiaries as a single corporation for income tax purposes. As discussed in the Center’s analysis of H.R. 1956, one of the bill’s most damaging features is that its nexus “safe harbors” apply separately to each individual subsidiary in a multi-corporate group. Accordingly, H.R. 1956’s enactment would enable many corporations to “wall-off” a considerable share of their profits in one subsidiary that would no longer have nexus in a particular state under the bill while using another subsidiary to conduct activities in the state that require amounts or types of “physical presence” that are not protected by the bill’s “safe harbors.”³⁵ Combined reporting would often defeat these kinds of strategies.

While it is true that adopting combined reporting would significantly reduce the states’ vulnerability to many of the kinds of tax-sheltering opportunities that would be opened up by the enactment of H.R. 1956, its proponents are not telling the whole story in touting this policy:

- Only about one-third of the states with corporate income taxes have adopted combined reporting to date, despite the fact that it nullifies many tax-avoidance opportunities available to corporations under *existing* law. Only one state (Vermont) has adopted combined reporting in the last 20 years, and it does not go into effect until January 1, 2006.
- Most multistate corporations — and the lobbying organizations to which they belong — vigorously oppose combined reporting wherever it is under consideration. Combined reporting bills were introduced in twelve state legislatures in 2003-5, and business opposition helped defeat it everywhere but in Vermont.³⁶ The Council on State Taxation (COST), which supports H.R. 1956 and claims to be neutral on state adoption of combined reporting, had this to say about it before the Vermont legislature in early 2004:

The concept of a “unitary business” is a uniquely factual issue and is yet poorly defined. . . . [I]t is subject to endless litigation. California, the first state to impose unitary combined reporting, should have all the wrinkles in the system ironed out. But it doesn’t. California currently has unresolved taxpayer disputes that are literally decades old. . . . One of the difficulties in moving . . . to a mandatory unitary combined reporting method is the additional complexity inherent in treating separately incorporated companies as one business group. Few tax professionals. . . have the training and background necessary to properly administer such a system. Many fundamental but extraordinarily complicated decisions are inherent in the administration of a functional combined reporting system. . . .³⁷

Other business organizations that are unabashed in their opposition to combined reporting are even more harshly critical.

- Combined reporting can only nullify the adverse effects of H.R. 1956 on a state’s revenues in cases in which a corporation has at least one subsidiary in that state that will continue to have nexus even after the bill is in effect. In many instances that will not be the case. For example, combined reporting won’t preserve tax payments being received from a bank that has one subsidiary making car loans to the states’ residents and another making credit card loans if neither subsidiary has employees or physical property in the state.
- Switching to combined reporting to counteract H.R. 1956’s effects would face the same kinds of procedural hurdles in state legislatures (such as supermajority requirements) discussed above

with respect to throwback/throwout rules.

- In order to preserve a substantial share of the corporate income tax revenue that would be lost from the enactment of H.R. 1956, it would not be enough for states to adopt combined reporting. They also would have to implement a specific, technical feature of combined reporting involving the assignment to combined reporting states of sales made by related corporations that would be protected from nexus in the combined reporting state by the provisions of H.R. 1956.³⁸ Only 3 of the 16 combined reporting states have this specific sales-assignment policy in effect at present.³⁹

The “Sham Transaction Doctrine” and Other Ad Hoc Attacks on Tax Shelters

In addition to royalty addback laws and combined reporting, proponents of H.R. 1956 cite a variety of ad hoc approaches that states could use to nullify tax sheltering opportunities that might “hypothetically” be opened up by the bill’s enactment. Indeed, the following provision ostensibly aimed at preserving such approaches was added to the bill when it was marked-up by a House Judiciary subcommittee on December 13, 2005:

Preservation of Authority. — This section shall not be construed to modify, affect, or supersede the authority of a State to bring an enforcement action against a person or entity that may be engaged in an illegal activity, a sham transaction, or any perceived or actual abuse in its business activities if such enforcement action does not modify, affect, or supersede the operation of any provision of this Act or of any other federal law.

This language notwithstanding, states have only rarely attempted and have not had much success in defending in court the kinds of ad hoc approaches to nullifying tax shelters that rely on general anti-abuse authority in state tax codes. For example, demonstrating that a Delaware Intangible Holding Company is a complete “sham” is a very fact-specific undertaking that requires substantial legal, accounting, and economic-analysis resources that few states can muster in very many instances.⁴⁰ In reality, few IHCs are “shams;” an entire industry of tax lawyers and accountants has developed in Delaware and Nevada aimed at providing these entities with enough superficial “economic substance” and “business purpose” to withstand such challenges from state tax authorities. Given the practical hurdles that states would face in challenging tax-shelter opportunities created by H.R. 1956 under the “sham transaction doctrine” and other ad hoc approaches, the claim that the states retain the legal authority to do so is not meaningful.

Conclusion

H.R. 1956 is intended to — and would — block many states from taxing the profits of many corporations they are now taxing. Under current law in many states, the profits that would be non-taxable under H.R. 1956 would not automatically flow into the corporate tax base of some other state(s); they would not be taxed anywhere. Thus, claims by proponents of H.R. 1956 that its enactment would not lead to any significant revenue loss for the states collectively are simply false.

State laws could be changed to ensure that profits that a particular state would be barred by H.R. 1956 from taxing *would* be taxed by another state. State laws could also be amended to nullify some

of the new tax sheltering opportunities that the Center's other reports on H.R. 1956 have described. However, the multistate corporate community has been quite active and quite successful in recent years in blocking states from enacting these kinds of changes in their tax laws. Thus, it is disingenuous of proponents of H.R. 1956 to dismiss state concerns about the revenue impact of the legislation by asserting that states have ample tools to prevent these losses from occurring. The business community is doing everything in its power to make sure these tools are not available to state tax administrators — and thereby ensure that the enactment of H.R. 1956 would lead to substantial reductions in corporations' tax payments to states in the aggregate.

Notes

¹ No Senate counterpart to H.R. 1956 has been introduced.

² National Governors Association, *Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, On States*, September 26, 2005, www.nga.org/Files/pdf/0509BAT.PDF.

³ H.R. 1956 applies equally to BATs imposed by local governments. This paper generally refers to states alone, however, because most of the discussion in it is applicable to corporate income taxes. Corporate income taxes are not commonly imposed by local governments, with the prominent exceptions of New York City and the District of Columbia.

⁴ One of the amendments adopted in the subcommittee mark-up clarifies that the 21-day limit applies to employees and property combined. In other words, a corporation that had employees in a state on 15 days and property in the state on an additional 10 days would be outside the 21 day limit; a state would not be barred from asserting nexus over the company. As discussed in the previously-published Center analysis of H.R. 1956, however, such a provision is largely meaningless because a corporation that wished to have employees in a state for 15 days and property in the state for 10 more without establishing nexus could easily incorporate a separate subsidiary to be the nominal owner of the property. In that event, neither corporation would exceed the 21-day limit. The limit applies separately to each separately-incorporated subsidiary in a group of commonly-owned and commonly-controlled corporations.

⁵ Letter dated September 27, 2005 from Arthur Rosen on behalf of the Coalition for Rational and Fair Taxation in support of H.R. 1956 to the Chairman of the Subcommittee on Commercial and Administrative Law, House Judiciary Committee. Hereafter referred to as the “CRAFT Statement.”

⁶ Proponents of H.R. 1956, including CRAFT, frequently characterize the *entire bill* as doing nothing more than establishing a “physical presence” nexus standard. That characterization is misleading. A physical presence nexus standard would mean that if a corporation had no physical presence in a state it would not be taxable there, and if it had a physical presence it *would* be taxable. In contrast, H.R. 1956 provides several new “safe harbors” that would allow a corporation to have substantial physical presence in a state without creating nexus, and it also preserves Public Law 86-272, which allows a corporation to have sales and delivery personnel in a state without creating nexus. Nonetheless, the quoted language is one provision of H.R. 1956, and — operating independently of the rest of the bill — it *would* establish a “physical presence” standard. That is why it is referred to in this section as the “true” physical presence threshold in the bill.

⁷ See: Affidavit of Thomas K. Condon, Massachusetts Department of Revenue, in the case of *Prime Receivables Corporation v. Alan LeBovidge*, dated December 3, 2003. This document indicates that a number of large multistate banks with customers in Massachusetts but no direct physical presence there dropped their challenges to the state’s bank income tax, which asserts that nexus is established if out-of-state financial institutions have a significant number of Massachusetts-resident customers. See the longer discussion on pp. 6-7 of this report.

⁸ See: Michael Mazerov, *Federal “Business Activity Tax Nexus” Legislation: Half of A Two-Pronged Strategy To Gut State Corporate Income Taxes*, Center on Budget and Policy Priorities, Revised November 30, 2005.

⁹ Indeed, Public Law 86-272 allows the seller to have a substantial physical presence in its customers’ state(s) without creating nexus — so long as that physical presence is limited to sales and delivery personnel and their “ancillary” equipment (such as vehicles).

¹⁰ See for example, the recent *Lanco*, *MBNA*, and *A&F Trademark* decisions in New Jersey, West Virginia, and North Carolina, respectively. Earlier cases in New Mexico, South Carolina, and Maryland had also found that physical presence was not required to establish corporate income tax nexus. In contrast, court decisions in Alabama, Missouri, Texas, and Tennessee have found that physical presence is required for corporate income tax nexus.

¹¹ CCH, *2005 Multistate Corporate Tax Guide on CD ROM*.

¹² See the source cited in Note 7.

¹³ Tennessee and West Virginia are two of a number of states (in addition to Massachusetts) with an “economic presence” nexus standard applicable to financial institutions. Tennessee’s standard was successfully challenged in *J.C. Penny National Bank v. Johnson*, 1999. The authority of West Virginia to tax non-physically-present banks was upheld in *Steager v. MBNA America Bank, N.A.* (2005; on appeal).

¹⁴ See Indiana Letter of Findings 01-0349; December 1, 2003, and North Carolina Final Decision in Docket No. 01-550, July 1, 2004.

¹⁵ Furthermore, as suggested by CRAFT’s reference to “outside the context of passive investment companies,” at least a few states are undoubtedly collecting some BAT revenues from corporations with no physical presence within their borders. Legal decisions have been rendered in Maryland, New Jersey, New Mexico, North Carolina, and South Carolina upholding the authority of these states to require out-of-state “passive investment companies” to pay corporate income taxes when they earn income in the state by licensing trademarks to in-state corporations. Given these decisions, it seems likely that at least some non-physically-present corporations (beyond the “passive investment companies” actually involved in the cases) are paying corporate income taxes to the three states. New Mexico and South Carolina would lose those revenues if their decisions were effectively reversed by the enactment of H.R. 1956. (The other three states have enacted targeted anti-passive investment company legislation, discussed on page 11-12 of this report, and would probably not lose significant revenue if their passive investment company decisions were nullified by the enactment of H.R. 1956.)

¹⁶ An article on the Web site of the International Franchise Association acknowledges that such in-state activities as “regular and repeated visits of franchisor personnel to the franchised locations in the state [and] the holding of training sessions or franchisee meetings in the state” are commonly engaged in by franchisors and are nexus-creating. See: Neal D. Borden and Theresa J. Withers-Williams, *State Taxation of Franchise Royalties and Fees — an Update*, February 1, 2003. Available at: www.franchise.org/printarticle.asp?article=1040. See also the friend-of-the-court brief filed by the International Franchise Association in the recently-denied appeal to the U.S. Supreme Court of the North Carolina *A&F Trademark* case: “A franchisor’s employees may make occasional visits to its franchisee’s place of business to assist the franchisee in opening his business and to inspect the franchisee’s performance and furnish advice and guidance, but the duration of such visits normally is a few hours or days.”

IFA’s attempt to minimize the significance of such physical presence is belied by the simple observation that a major franchisor might have hundreds of franchisees in a particular state, requiring virtually a 365 day per year presence of at least one of its employees in the state. In a 1975 U.S. Supreme Court case, the taxpayer claimed that the year-round presence of a single employee was too inconsequential to justify a finding of nexus; the Court responded that the claim “verges on the frivolous.” (See: *Standard Pressed Steel Co. v. Washington Department of Revenue*.)

¹⁷ Under H.R. 1956, if a franchisor hired an independent company to perform quality-control checks at its franchisees’ stores, this would not establish BAT nexus for the franchisor as long as the independent company performed the same service for more than one franchisor.

¹⁸ 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, especially the Appendix. See also: Staff of the California Franchise Tax Board, “California FTB Analyzes Business Activity Tax Proposal in H.R. 3220,” *State Tax Notes*, May 31, 2004. H.R. 3220 was the almost identical predecessor of H.R. 1956 introduced in the previous session of Congress.

¹⁹ The operation of the throwback rule is discussed in 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. An unpublished memo explaining the difference between throwback and throwout rules is available from the author upon request.

²⁰ 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.

²¹ In 2004 testimony on the predecessor bill to H.R. 1956, CRAFT spokesperson Arthur Rosen explicitly referred to throwback rules as one mechanism that would enable states to avoid losing revenue were the bill to be enacted. See:

Hearing on H.R. 3220 before the Subcommittee on Commercial and Administrative Law, House Judiciary Committee, May 13, 2004, p. 45.

²² Again, throwback and throwout rules have already been enacted in many states because they are needed to prevent the creation of “nowhere income” even under the limited nexus safe harbor of P.L. 86-272.

²³ Under state corporate income tax laws, sales of services generally are deemed to be made in the state in which the “greater proportion of income-producing activity” entailed in providing them takes place, not in the state in which the customer is located. (This is in contrast to the default rule for sales of goods, which treats the sale as occurring in the state in which the customer accepts delivery.) The “greater proportion” rule tends to reduce the amount of completely untaxed “nowhere income” that sellers of services receive, because the income-producing activity involves the use of employees and physical property (which create nexus). Thus, even if H.R. 1956 made it harder for the service customer’s state to establish nexus over the interstate seller of a service, the “greater proportion” rule would tend to assign the profit to a state that has nexus over the seller. In other words, the “greater proportion rule” for services tends to have the same effect as a throwback rule in preventing nowhere income.

An increasing number of states, however, are implementing rules that assign sales of services to the state where the customer is located, just as sales of goods are assigned. These rules are most often being applied to financial services, advertising, and publishing. This trend has been acknowledged by CRAFT’s own lobbyist. (See roundtable of the CCH state tax advisory board, *CCH State Tax Review*, October 4, 2005: “You’ve seen on the East Coast with the financial services industries first, and I’ve seen this spreading around the country, focusing on sourcing receipts for services to where the market is, as opposed to cost-of-performance.”) The enactment of H.R. 1956 would be likely to increase the amount of “nowhere income” received by sellers of services that receive this “destination sourcing” treatment unless these states enacted a throwback rule covering services.

Moreover, the “greater proportion” rule itself is ambiguous and subjective. If H.R. 1956 were enacted, corporations would have significant incentives to claim that the greater proportion of their income-producing activities occurs in their customers’ states (where they would often no longer have nexus), since this would create “nowhere income.”

²⁴ See, for example, a letter dated May 12, 2005 from the Council on State Taxation to the Honorable James W. Crawford, Jr., Chair of the North Carolina House of Representatives Appropriations Committee, in opposition to the throwout rule contained in Senate Bill 622.

²⁵ New Jersey enacted the throwout rule in 2002; a business-dominated corporate tax study commission there has recently called for its repeal. Intense business lobbying contributed to the recent defeat of legislation implementing the throwback rule in Maryland and the throwout rule in North Carolina. Business-dominated tax study commissions in Arizona and Pennsylvania have recently called on policymakers in those states to forswear the enactment of throwback/throwout rules.

²⁶ National Conference of State Legislatures, *State Tax and Expenditure Limits, 2005*, available at www.ncsl.org/programs/fiscal/tels2005.htm.

²⁷ See the Center report cited in Note 18.

²⁸ For a list of companies that have implemented the IHC tax shelter, including the Gap and The Limited, see: Glenn R. Simpson, “A Tax Maneuver in Delaware Puts the Squeeze on Other States,” *Wall Street Journal*, August 9, 2002. Both companies are signatories to a letter supporting the enactment of H.R. 1956 dated December 13, 2005 and sent to Representative Jim Sensenbrenner, Jr., chair of the House Judiciary Committee.

²⁹ See the discussion in Notes 10 and 15. See the source cited in Note 11 for a list of more than 25 states that take the position that licensing a trademark to a store in the state creates nexus. State court decisions in Alabama, Missouri, and Texas have held that states do *not* have nexus over out-of-state IHCs.

³⁰ “[S]tates have now moved on to using other, more effective attacks against passive investment companies [another term applied to IHCs], such as the economic substance and *alter ego* arguments, combined reporting, and the denial of the relevant deductions.” (Source: footnote 41 of the September 27, 2005 CRAFT Statement on H.R. 1956.)

³¹ See the source cited in Note 19.

³² 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 (the predecessor bill to H.R. 1956 introduced in the 108th Congress) 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.” H.R. 3220 is virtually identical to H.R. 1956.

³³ COST letter to members of the House of Representatives in support of H.R. 2526, dated July 16, 2002. H.R. 2526 was the version of the BAT nexus legislation introduced during the 107th Congress.

³⁴ See, for example, Thomas H. Steele and Pilar M. Sansone, “Surveying Constitutional Theories for Challenges to the Add Back Statutes,” February 23, 2005. Available on the Web site of the Morrison and Foerster law firm.

³⁵ In particular, see the Appendix of the Center on Budget and Policy Priorities report cited in Note 18 for a discussion of how these tax shelter opportunities could be implemented.

³⁶ Vermont became the first state in more than 20 years to adopt combined reporting, and the Vermont-based business community did not oppose it vigorously because it was sweetened with a sharp cut in the corporate tax rate.

³⁷ Testimony of COST Legislative Director Joseph R. Crosby before the Vermont Ways and Means Committee, March 25, 2004.

³⁸ Discussion of this so-called “Finnigan/Joyce” issue (named for the California court decisions that first raised it) would be quite technical and is beyond the scope of this report. See the California Franchise Tax Board report cited in Note 18 for a discussion of how even combined reporting states likely would lose substantial corporate tax revenue from the enactment of H.R. 1956 unless they switched to the “Finnigan” policy of assigning the sales of non-nexus corporations in a unitary combined group to the sales factor numerators of the unitary group members that would retain nexus in the combined reporting state.

³⁹ Arizona, Kansas, and Utah have adopted the “Finnigan” rule, according to the *CCH 2005 Multistate Corporate Tax Guide on CD ROM*.

⁴⁰ For example, after a long and no-doubt expensive litigation effort, Massachusetts was defeated in its effort to demonstrate that the Delaware Intangible Holding Company of the paint manufacturer, Sherwin-Williams, was a sham entity.