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Proposed “Business Activity Tax Nexus” Legislation Would Seriously Undermine State Taxes on Corporate Profits and Harm the Economy

By Michael Mazerov

A bill introduced in the U.S. House of Representatives would strip states and localities of their current authority to tax a fair share of the profits of many corporations that are based out-of-state but do business within their borders. It would reduce state and local governments’ revenues by at least \$2 billion in the very first year after enactment, impairing their ability to fund education, health care, public safety, and other essential services. Representative Steve Chabot reintroduced this bill, the “Business Activity Tax Simplification Act” (“BATSA”), H.R. 2584, on June 1, 2015. The House Judiciary Committee approved the bill on June 17. The timing of full House consideration of the bill is uncertain.

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

- The legislation would cause state and local governments collectively to lose substantial tax payments from out-of-state corporations that would be freed from their current obligations to pay taxes on their profits and gross sales to particular jurisdictions. A significant share of currently-taxable corporate profits would go untaxed by *any* state, leading to a net revenue loss for the states as a whole. According to a Congressional Budget Office (CBO) estimate done in 2011 on an identical version of the bill, state and local revenue losses would be \$2 billion annually in the first full year after enactment and likely to grow in subsequent years.

State corporate income tax receipts have not recovered from the 2007-08 recession. In 2014, they were still 12 percent below their pre-recession peak — and that is before adjusting for erosion in their purchasing power due to inflation. Additional loss of revenue in the next few

years would undermine state funding for education, health care, public safety, infrastructure, and other services important for states' long-term prosperity.

- BATSA would block particular states from taxing particular corporations on income earned in those states. Even if those corporations' profits might ultimately be taxed by their home states, BATSA still would unfairly deprive other states and localities of their right to tax the profits of specific out-of-state corporations that benefit from services these jurisdictions provide to them.
- BATSA would stimulate a wave of new corporate tax sheltering activity aimed at cutting state and local business tax liabilities, which would stimulate demand for tax lawyers and accountants but reduce economic productivity and competitiveness.
- The legislation would mire state and local governments and corporations alike in a morass of litigation over whether particular businesses are or are not protected from taxation under the numerous vaguely defined provisions of BATSA — another outcome that would benefit lawyers and accountants at the expense of everyone else.
- BATSA would reward major multistate corporations that have the resources to engage in aggressive tax-avoidance behavior with much lower tax burdens than their small, locally oriented competitors, thereby handing small businesses a competitive disadvantage.

For example, if BATSA were enacted:

- A television network would not be taxable in a state even if it had affiliate stations and local cable systems there relaying its programming and regularly sent employees into the state to cover sporting events and to solicit advertising purchases from in-state corporations.
- A bank would not be taxable within a state even if it hired independent contractors there to process mortgage loan applications and the loans were secured by houses located within the state.
- A restaurant franchisor like Pizza Hut or Dunkin' Donuts would not be taxable in a state no matter how many franchisees it had in the state and no matter how often its employees entered the state to solicit sales of supplies to the franchisees or to train the franchisees in company procedures.

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

A compelling case for tighter federal limits on the authority of states to impose corporate profits taxes on out-of-state corporations has not been made. If, nonetheless, Congress decides to act in this area, workable and fair alternatives to BATSA are available. A proposed taxing jurisdiction (or "nexus") standard developed by the Multistate Tax Commission, for example, would base taxing authority on relatively objective measures of the dollar amount of a business' sales occurring in a

state, the dollar amount of property located in a state, or the dollar amount of payroll paid to employees working in a state.¹ Such an approach balances the legitimate objective of preventing states from imposing the burdens of complying with a business activity tax on a company that has relatively little activity in the state — and therefore little tax liability — with the right of states to tax income earned within their borders by businesses that are benefiting from state and local services and the organized marketplace the state provides.

What Would BATSA Do?

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

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

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

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

- extending it to the entire service sector of the economy; and
- extending it from income taxes to all business activity taxes; and

- establishing numerous new “safe harbors” from nexus (while retaining the safe harbors for in-state solicitation and delivery). For example, under BATSA a corporation could have an unlimited number of employees or an unlimited amount of equipment or other property in a state for up to (and including) 14 days per year without establishing BAT nexus.

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

Adverse Impacts of BATSA on State Finances and Corporate Tax Fairness

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

- *Substantial loss of state corporate tax revenue in the aggregate.* BATSA would cause a large majority of states to lose substantial corporate profits tax payments (and other BAT payments as well) from out-of-state corporations that would no longer be subject to tax because of the higher nexus threshold that would be established by the bill. The untaxed profits frequently would not be taxed by the state(s) in which the corporations remained taxable, either, leading to a substantial net loss of corporate tax revenue for states in the aggregate.
 - *Example.* A Maryland-based industrial equipment manufacturer takes its orders over the Internet but has nexus in every state in which it has customers because its employees install that equipment at its customers’ place of business. Under BATSA, this manufacturer could easily arrange to have corporate income tax nexus only in Maryland. The bill provides that the use of an agent in a state does not create nexus so long as the agent has more than one client. The clients may be related to the agent through common ownership. The manufacturer could bring itself under this safe harbor by forming one subsidiary to employ the equipment installers and two others to manufacture the equipment (say, one subsidiary to manufacture Product A and another to manufacture Product B). Such a restructuring would make the installation subsidiary the agent of two legally distinct manufacturer “clients.” This would satisfy the terms of the “safe harbor” in BATSA and block all states except Maryland from taxing the corporation’s profit from equipment sales. Because of how Maryland taxes the profits of multistate corporations, none of the corporation’s profit earned on equipment sales made to non-Maryland customers would be taxable in Maryland, either — meaning that this corporation’s total tax payments to the states taken together likely would drop precipitously.⁴ Multiply this scenario by thousands of businesses in scores of states, and it becomes clear that the aggregate loss of state corporate income tax revenue would be substantial.

In 2011, CBO estimated that the enactment of a version of BATSA that is identical to H.R. 2584 would have led to lost revenues for state and local governments that “would be about \$2 billion in the first full year after enactment and at least that amount in subsequent years.” CBO also observed: “Subsequently, corporations likely would rearrange their business activities to take advantage of beneficial tax treatments that would result from the interaction of the new

federal law and certain state taxing regimes. Those changes in business activities would likely result in additional revenue losses to the states” beyond the \$2 billion immediate impact.⁵

- *Individual states deprived of their fair share of tax revenue.* Regardless of whether BATSA enabled a particular corporation to pay less business activity tax in total, the bill would deprive individual states of their fair share of taxes from out-of-state corporations earning profits within their borders and benefiting directly from public services the states provide.
 - *Example.* A Massachusetts bank makes home mortgage loans to Connecticut borrowers who apply for the loans over the Internet or during an in-home visit by an independent mortgage broker engaged by the bank. The borrowers go to settlement at a Connecticut title company of their choice. BATSA would block Connecticut from taxing the bank’s profits on those loans: the bank has no employees and owns no property in Connecticut, and its use of Connecticut brokers and settlement agents does not create nexus because the companies provide these services to multiple banks. Connecticut is barred from taxing any of the bank’s profits on Connecticut home loans despite the fact that the banks use Connecticut’s courts to foreclose on delinquent loans and the value of the homes that serve as mandatory collateral for the loans is crucially dependent on the quality of local schools, parks, roads, and police and fire protection provided by Connecticut and its local governments. Under provisions of Massachusetts’ bank taxation law, Connecticut’s inability to tax the bank likely would result in the bank’s paying tax on profits from the Connecticut loans to Massachusetts instead.⁶ Nonetheless, BATSA would deny Connecticut its fair share of tax on profits earned within its borders by a corporation that is benefiting from public services Connecticut provides to the bank, the bank’s collateral, and the bank’s in-state settlement agents.
- *Hamstringing state efforts to stop abusive tax sheltering.* BATSA would block states from asserting corporate income tax nexus over out-of-state companies that license trademarks to related in-state businesses. This would deprive states of a key tool they are using to shut down perhaps the most abusive state corporate tax shelter in widespread use.
 - *Example.* Under a tax shelter employing a so-called “intangible holding company” (IHC), a corporation operating retail stores like The Limited transfers its trademarks to a subsidiary corporation it has created in a tax-haven state like Delaware or Nevada. The stores then pay royalties to this subsidiary for the use of the trademarks. These royalties are tax-deductible (as a cost of doing business) and hence can be used to largely or entirely eliminate corporate income tax liability in the states in which the corporation is actually doing business and earning its profits.⁷ Meanwhile, the royalty payments are not taxed by the tax-haven state. Almost two-thirds of the states with corporate income taxes seek to nullify this tax shelter by asserting that the IHC is directly taxable in any state from which it receives royalties.⁸ BATSA would close off this avenue of attack on IHCs by providing that the presence in a state of an intangible asset like a trademark does not create BAT nexus for the out-of-state corporation that owns it. In so doing, BATSA would reverse court decisions in Louisiana, Maryland, Massachusetts, New Jersey, New Mexico, North Carolina, Oklahoma, and South Carolina that held that IHCs had nexus in those states, as well as repeal the nexus policy of at least 21 additional states.⁹

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

- *Opening up vast new tax-avoidance opportunities.* BATSA would open up enormous new opportunities for corporations to shelter their profits from taxation in states in which the profits are earned by dividing themselves into separate legal entities (such as a parent corporation and several subsidiary corporations). For example, the bill provides that a corporation can send an unlimited number of employees and an unlimited amount of equipment into a state without establishing BAT nexus so long as the employees and equipment are not in the state for more than 14 days in a calendar year. However, this 14-day limit — like all the “safe harbors” from nexus in BATSA — applies separately to every individual corporation in a multi-corporate group.
 - *Example.* A business providing on-site computer repair and troubleshooting services needs to have employees in a neighboring state an average of 180 days per year. However, it would like to avoid triggering BAT nexus in the neighboring state because the corporate tax rate in its home state is lower. The company could achieve both objectives with modest legal and accounting costs by incorporating 13 different subsidiaries to employ its repairmen and rotating responsibility for providing service in the neighboring state among those subsidiaries at 14-day intervals. If the company were too small to employ 13 repairmen, it could rotate their employment among the subsidiaries as well.

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

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

Adverse Impacts of BATSA on the Economy

Enactment of BATSA also would adversely affect the economy.

- *Degraded public services.* As noted above, CBO has concluded that the enactment of BATSA would cause state and local governments to lose approximately \$2 billion in annual revenues almost immediately and even more after corporations have an opportunity to restructure their operations to take advantage of the tax-sheltering opportunities the bill creates. By depriving states of business activity tax revenues they currently are collecting, the legislation could further impair their ability to provide services that are a critical foundation of a healthy national economy — such as high-quality K-12 and university education and transportation infrastructure.
- *Costly litigation.* The U.S. Supreme Court’s 1992 *Quill* decision reaffirmed a 1967 decision that

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

- *Example.* BATSA provides that having employees or property in a state in order to conduct “limited or transient business activity” does not create nexus. Neither “limited” nor “transient” is defined in BATSA. An exemption for “limited” activity could imply that a business will not be taxable in a state if it does not engage in the full range of activities involved in its business; for example, a manufacturer might not be taxable in a state in which it had a sales office but not one of its manufacturing plants. An exemption for “transient” presence means that a business might never be taxable in a state its employees entered temporarily no matter how many days per year they spent there. Given this ambiguity and the enormous revenue consequences for the states flowing from how just these two terms in BATSA might be interpreted, their enactment into law would be a prescription for constant litigation until the Supreme Court supplied some measure of clarity. In the case of the meaning of the term “solicitation” in P.L. 86-272, that was a period of more than *30 years*.
- *Economically sub-optimal business location decisions.* A physical presence nexus threshold may interfere with the efficient allocation of economic resources by creating an artificial disincentive for the placement of facilities in states where fundamental economic considerations might otherwise dictate they should be located. As a former Director of the Oregon Department of Revenue has argued:

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

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

- *Artificial competitive advantage for the most aggressive tax-avoiders.* Enactment of BATSA would result in significant differences among corporations in the effective rate at which their profits are taxed — tilting the playing field to the competitive advantage of some corporations and the disadvantage of others. BATSA would reward with the lowest state corporate tax liability those corporations willing to implement the most aggressive corporate restructuring and tax-avoidance strategies — such as the intangible holding company tax shelter discussed above. Large corporations with multistate operations would have much greater expertise, resources, and opportunities to implement these strategies than would small, family-owned corporations serving a local market.
- *Example.* A multistate bookstore chain places computer kiosks in all its stores. The kiosks are linked to its Internet operation. Store employees help customers place orders for books not available in the store at the kiosks. The stores advertise the address of the website in all their advertising. The stores even accept returns of unwanted books purchased at the website. Despite this critical sales assistance provided by the stores to the online operation, under BATSA the Internet operation could easily avoid having to pay tax on its profit to any state(s) except the one(s) where it has offices, warehouses, or similar facilities.¹⁶ The owner of a local independent bookstore, on the other hand, lacking the resources to set up an out-of-state electronic commerce website and distribution facility, would have 100 percent of his profit subject to taxation by the state in which the store is located.

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

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

Thus, it is inconsistent for the supporters of BATSA now to propose permanently enshrining substantial in-state “physical presence” as the threshold for the imposition of state business activity taxes. And it is incorrect for them to characterize this as a “modernization” of P.L. 86-272. Given the numerous organizational strategies and technologies corporations can now employ to make substantial sales and earn substantial profits in a state without actually being physically present within its borders, it is clear that a physical presence nexus threshold is obsolete and unfair. It really cannot be argued seriously that states should be barred from taxing the profits of a corporation like Pizza Hut because it chooses to franchise its ubiquitous restaurants rather than own them directly. That is the kind of step backward in tax policy that BATSA would implement.

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

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

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

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

- Walt Disney (owner of ABC), CBS, Discovery, and Time Warner would benefit from the expansion of P.L. 86-272 to encompass service businesses, since this would insure that in-state solicitation of advertising contracts from major corporations would not establish BAT nexus for these companies' television networks. They would also benefit from the safe harbor permitting employees to be present in a state gathering news and covering events without establishing nexus.
- A corporation like General Electric would likely benefit from a new safe harbor from nexus for any activities conducted in a state for up to 14 days by its employees or for an unlimited amount of time by one of its own subsidiaries.²⁰ Presumably many G.E. products, such as medical imaging equipment, are complex and often require on-site installation or trouble-shooting assistance from G.E. employees — a post-sale activity not currently protected by P.L. 86-272.
- BATSA would benefit corporations like The Limited and The Gap, which have been sued by multiple states claiming that their trademark holding companies had nexus in those states. As explained above, BATSA would put an end to such litigation in the future and hinder state efforts to shut down this tax shelter.
- A company like UPS, which operates warehouses in which independent companies like Internet

retailers store their inventory for quick delivery to customers, would benefit from a new safe harbor that provides that nexus is not created by the use of such third-party “fulfillment” services.

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

Rational and Fair Alternatives to BATSA Are Available

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

A nexus threshold based on the volume of sales in a state can achieve this balancing of tax compliance costs and tax liability in a direct, administrable manner. Reasonable people can disagree about what the threshold should be. If business and state and local government representatives are unable to agree, Congress can be the final arbiter — just as Congress would be in proposed legislation establishing a sales-based nexus threshold for sales taxation. The “Marketplace Fairness Act” (S. 698) would empower any state adopting a prescribed set of measures aimed at simplifying its sales tax to require a non-physically present retailer to collect the state’s sales tax if the seller has more than \$1 million in nationwide sales.

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

If Congress is determined to act in this area, a better approach would be to repeal P.L. 86-272 and substitute a nexus threshold based entirely on objective, quantitative measures of in-state business presence and activities. The \$1 million sales threshold in the current version of the Marketplace Fairness Act or the Multistate Tax Commission’s “factor presence” nexus standard (which looks to

the dollar amount of property, payroll, or sales located in a state) would be good starting points for congressional consideration.

Notes

¹ Multistate Tax Commission, “Factor Presence Nexus Standard for Business Activity Taxes,” October 17, 2002, http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

² Corporate income taxes are levied by 44 states, the District of Columbia, and New York City. In 2012 these taxes supplied \$49 billion to state and local treasuries.

³ “CRAFT believes that the bright-line, quantifiable physical presence nexus standard, as provided in the Business Activity Tax Simplification Act of 2015 (BATSA), is the appropriate standard for state and local taxes imposed directly on out-of-state businesses.” Statement of Arthur R. Rosen before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary, U.S. House of Representatives on BATSA and other bills, June 2, 2015.

⁴ Like the majority of states levying corporate income taxes, Maryland taxes the profits of multistate manufacturers only in proportion to their sales to Maryland customers. Accordingly, a Maryland-based manufacturer with no customers in Maryland would pay no corporate income tax to the state. Moreover, like roughly half the states, Maryland has not enacted a “throwback rule” to subject to taxation the profits earned by a Maryland manufacturer in other states in which the manufacturer has not established nexus. As a result of the combination of these two corporate income tax “apportionment” policies, the lion’s share of the nationwide profit of a Maryland manufacturer that was protected from taxation in other states by BATSA would be “nowhere income” — profit that would not be taxed by any state. The interaction between BATSA and rules like those of Maryland that base corporate income tax liability on in-state sales alone are discussed in a separate Center report. See: Michael Mazerov, *Federal “Business Activity Tax Nexus” Legislation: Half of a Two-Pronged Strategy to Gut State Corporate Income Taxes*, Center on Budget and Policy Priorities, revised May 13, 2011, <http://www.cbpp.org/research/federal-business-activity-tax-nexus-legislation-half-of-a-two-pronged-strategy-to-gut-state>.

⁵ CBO Cost Estimate for H.R. 1439, September 13, 2011, http://www.cbo.gov/sites/default/files/cbofiles/attachments/hr1439_2.pdf.

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

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

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

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

⁸ John C. Healy and Michael S. Schadewald, 2015 *Multistate Corporate Tax Guide*, “Economic Nexus (Part 1),” Wolters Kluwer, Volume 1, pp. 2089-2093.

⁹ The Maryland case upheld the state’s authority to require the intangible holding company of the Syms clothing chain to pay Maryland corporate income tax on the royalties it earned by licensing use of the Syms trademark to Maryland Syms stores. The analogous cases in the other states named involved Kmart, The Limited, The Gap, and Toys R Us. In

addition, the West Virginia Supreme Court upheld the authority of that state to impose its corporate income tax on an out-of-state bank issuing credit cards by mail to state residents.

¹⁰ Bills to implement one major anti-IHC mechanism, “combined reporting,” have been introduced since 2000 in the District of Columbia and at least 22 states: Alabama, Arkansas, Connecticut, Florida, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Missouri, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, Virginia, West Virginia and Wisconsin. Combined reporting was enacted in the District and in eight of the 22 states: Massachusetts, Michigan, New York, Texas, Vermont, West Virginia, and Wisconsin. Bills denying an income tax deduction for royalty payments to IHCs have been introduced since 2000 in at least 15 states that have not enacted combined reporting: Alabama, Arkansas, Connecticut, Georgia, Indiana, Kentucky, Maryland, Mississippi, Missouri, New Jersey, North Carolina, Pennsylvania, Rhode Island, Tennessee, and Virginia. They were not enacted in two: Missouri and Tennessee. In most of the other 13 states the bills were so watered down with numerous exceptions after intense business lobbying that they arguably will be largely ineffectual against IHCs. (See: Charles F. Barnwell, Jr., “Addback: It’s Payback Time,” *State Tax Notes*, November 17, 2008.) In short, despite the serious fiscal problems of the states in the recent years, the business community has had a decent track record in blocking the two approaches to shutting down the IHC tax shelter that require state legislative action.

Moreover, H.R. 2584 contains a provision that will substantially undermine the ability of combined reporting to nullify IHCs. The language will bar combined reporting states from assigning royalties received by IHCs to the states in which the trademark is used. This will result in a substantial revenue loss for many combined reporting states.

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

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

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

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

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

It sounds counterintuitive, but physical location is very important for the success of a virtual business. We could have started Amazon.com anywhere. We chose Seattle because it met a rigorous set of criteria. It had to be a place with lots of technical talent. It had to be near a place with large numbers of books. It had to be a nice place to live — great people won’t work in places they don’t want to live. Finally, it had to be in a small state. In the mail-order business, you have to charge sales tax to customers who live in any state where you have a business presence. It made no sense for us to be in California or New York.

Obviously Seattle has a great programming culture. And it’s close to Roseburg, Oregon, which has one of the biggest book warehouses in the world. We thought about the Bay Area, which is the single best source for technical talent. But it didn’t pass the small-state test. I even investigated whether we could set up Amazon.com on an Indian reservation near San Francisco. This way we could have access to talent without all the tax consequences. Unfortunately, the government thought of that first.

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

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

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

¹⁸ “The underlying principle of this legislation is that only states and localities that provide meaningful benefits and protections to a business — like education, roads, fire and police protection, water, sewers, etc. — should be the ones who receive the benefit of that business’ taxes, rather than a remote state that provides no services to the business. Statement of Arthur R. Rosen before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary, U.S. House of Representatives on BATSA and other bills, June 2, 2015.

¹⁹ The membership of the Coalition for Interstate Tax Fairness and Job Growth, which was organized to lobby for BATSA’s enactment, is available at <http://www.interstatetaxfairness.com/who-we-are/>. All of the corporations listed in the following bullets are listed as current members of the Coalition as of June 15, 2015.

²⁰ Recall again that a corporation can use a subsidiary to conduct activities on its behalf in another state for an unlimited number of days in a year without thereby establishing nexus so long as the subsidiary works for at least one other subsidiary. See Note 16.

²¹ Michael Mazerov, “Proponents’ Case for a Federally Imposed Business Activity Tax Nexus Threshold Has Little Merit,” Center on Budget and Policy Priorities, February 26, 2014, <http://www.cbpp.org/files/6-26-08sfp.pdf>.

²² See the source cited in Note 1.

²³ Another coalition lobbying in support of BATSA is the “Coalition for Rational and Fair Taxation” (CRAFT). See: Statement of Arthur R. Rosen before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary, U.S. House of Representatives on BATSA and other bills, June 2, 2015.